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# ELEMENTARY BANKING

BY

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In humble appreciation of

all that he has done

for the cause of higher education

in Bengal

## PREFACE TO THE FIRST EDITION

This book contains an elementary survey of the general principles of Commercial Banking theory meant as an introduction for the use of Indian students who would like to get clearer and firmer notions of the subject than they can obtain by reading any of the text books written by Western writers.

The fundamental principles of banking theory are explained in a simple way. This is a sort of synthesis of earlier studies made by acknowledged writers in the domain of banking and currency. The theoretical principles are described in the light of the most recent knowledge as set forth in literature which is not very easily accessible to most students. Banking is becoming a profession and a sound knowledge of theory is essential for success besides the accuracy and experience which banking practice can furnish. This little book will furnish the needed groundwork in banking theory.

*31st March, 1924.* B. RAMCHANDRA RAU.

## PREFACE TO THE SECOND EDITION

The aim of the revised and enlarged edition is not to explain the methods of book-keeping adopted by banks or the legal aspects of banking practice or to describe the banking operations in minute detail. As a teacher of fifteen years' standing I consider myself qualified to discuss these measures but I have set them aside for more detailed treatment in a separate volume. I have accordingly dealt with the part played by banks in the complex processes of our social economy. As an outsider practical bankers would certainly question my competency to deal with matters of banking practice in a thorough manner. I may be belittled as a " man of mere theory," but it must be borne in mind that " theory is the soul of facts." I have endeavoured to supplement each chapter by making reference to recent discussions on some of the aspects of banking credit dealt with in that chapter.

The oft-repeated subject as to how and in what manner bank deposits are created has been referred to in the section on bank deposits. The evolutionary practices in the matter of credit control are referred to in the section on the Central Bank of Issue. The banking remedies for checking the trade booms and depressions have been referred to in the appropriate section on bank advances. As a matter of fact every section has been enriched by substantial and useful additions with reference to the changing practices of

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# ELEMENTARY BANKING

the post-war gold standard, the development of open-market operations in New York, the growth of New York as a major lending centre and the narrowing of the gold points as a result of economies in the transport of gold.

The lack of authentic banking statistics properly compiled by authoritative people is a great drawback. A closer acquaintance with the detailed operations of our banking mechanism and the drawing of any orderly knowledge from a mass of these figures become impossible in the absence of detailed statistics, regularly collected and promptly published. Comparison with other countries is often indulged in by other writers on banking, but the few banking statistics that are available lie scattered in several places and are not placed on a plane of comparability with other countries. Details of the most vital features are not to be had anywhere in an easily accessible form. Nothing is so deplorable as the damming up of this source of knowledge and unless such figures, extending over fairly long series of years, are available in course of time no practical conclusions of any great value as regards quantitative or qualitative banking development can be drawn. Besides this there ought to be proper co-ordination of statistical work of different departments and the annual banking blue book should attempt to gather and publish such valuable statistics.

The lines of development of Indian banking and the detailed study of the present-day situation are dealt with in my books entitled Banks and the Money Market, Organised Banking in the Days of John

Company published by Messrs. Lal Chand & Sons and my Present-day Banking in India published by the Calcutta University. This is a companion volume to them.

My obligations are to the other writers who are mentioned in the bibliography. Although I have been very diligent in getting ideas on banking problems from all standard treatises on banking, my ability to approach the Indian banking conditions is curtailed to a great extent by the lack of bulletins published by banks stating their facts and figures in an intelligible manner. Barring the monthly notes of the Central Bank of India nothing valuable in this direction has been attempted by the other Indian joint-stock banks. It is a pity that a diligent student of Indian banking can secure more information on foreign banking systems than on the banking system of his own country.

*23rd January, 1933.* B. RAMCHANDRA RAU.

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# ELEMENTARY BANKING

## CHAPTER I

*Section I.*—Numerous definitions of word " bank "—the different view-points in study of banking—lack of one comprehensive definition—English Legislators' attempt—the I. C. Banking Enquiry Committee's solution—the futility of any definition.

*Section II.*—The work of the ' Commercial bank '—the Exchange bank—the Savings bank—the Investment bank—the Mortgage bank—the Co-operative Credit bank—the Industrial bank—the Labour bank—No such clean cut in actual banking practice.

*Section III.*—The view of the man in the street—the businessman's opinion—the Economist's eulogy—economy of precious metals—economic bridge between saver and entrepreneur—expert financial advice—promotion of thrift—stimulus to productive activity—nerve centre of the modern world—coiner of moral and business virtues—the governing arbiter of industrial organisation—the intermediary between different active economic groups—banking becomes international—the servant of the community.

### Section I.

#### Numerous Definitions.

Numerous are the definitions of the word ' bank ' that one comes across in economic text-books.[1] The diversity of modern banking operations in order to satisfy the changing needs of our dynamic society forbids all attempts at an exhaustive definition of the term ' bank.' The modern trend towards specialisation

[1] The most common definition is the following one : ' Banks are institutions dealing in credit and money.' This is very limited in scope and conveys quite an imperfect idea of the duties and services of the different kinds of modern banks.

and division of labour which so insistently appears in every department of our economic life, displays itself no less conspicuously in banking business. The evolution of different types of banking, each specialising in a particular field, renders particular emphasis on the several kinds of banks necessary. A general comprehensive definition to cover all types of banking concerns would be useless and unscientific. It can but lay its stress on the common kernel of truth underlying all these different kinds of banking institutions. However, it is customary on the part of all writers on banking to restrict the word ' bank ' so as to mean " a commercial bank." The orthodox theory of banking as taught in the English economic literature pertains to the business of commercial banks.

## Different Viewpoints in Study of Banking.

To take a commercial view is purely to study banking business from the viewpoint of the businessman. Banking business should also be studied from the standpoint of the economist. Banking business should be considered from the viewpoint of the banker. The full import of banking business can be grasped only when it is viewed according to these different angles of vision.

To the man engaged in commerce, the chief duty of the commercial bank is to furnish him with loans. The banker should be a partner financing his business ventures. He is to be a skilled and expert auxiliary and adviser. He is to provide ready money whenever there is a temporary lack of it. This is the principal help which the businessman expects from his bank.

To the economist a commercial bank's supreme function is to manufacture an inexpensive medium of exchange, thereby economising the use of metallic money to as large an extent as is possible. Its duty is to act as the guardian of the mechanism of credit. Credit which is so vitalising a force in modern society is manufactured by the banker. The banker is the creator, the disburser and the guarantor of credit. MacLeod says, " The banker coins heavy blocks or ingots of credit." And another well-known economist says " Banks are the scales that weigh the credit of communities and individuals and are therefore the only instruments that can properly gauge and supply the demand for credit and currency."

To the banker himself the bank is an institution for the gathering of profits. Whatever after-effects may flow from his operations he is mainly concerned with his own materialistic ends. The banker is generally anxious to magnify the sum-total of economic benefits which he performs to society but his willingness and anxiety is merely a translation of his desire to earn higher dividends.

## Lack of One Comprehensive Definition.

To attempt to define banking business from any one of these standpoints is to obtain a one-sided view of banking. A general definition of banking business would be a mere misnomer. Each type of bank should have its own definition explanatory of its specialising functions. French definitions of banking lay stress on the bill of exchange. It is impossible to

bring all these different conceptions [1] of the word "bank" under one common and comprehensive definition. Banking business in any country is an elastic one expanding its usefulness to serve the legitimate business needs of its customers. Banking business is strictly evolutionary adapting itself to the changing needs of the hour.

## English Legislators.

Legislators have clearly realised this difficulty and they have cut the Gordian knot by defining the word 'bank' as follows: "A bank includes a body of persons whether incorporated or not who carry on the business of banking." The wording of the English Finance Act of 1915 is equally vague and defines "bank" as a person or corporation carrying on *bona-fide* banking business.

## The I. C. Banking Enquiry Committee.

The Indian Central Banking Enquiry Committee refuses to provide a definition but recommends the

[1] Banks in different countries carry their business in different ways. Banks in England lay emphasis on deposits and the cheque-issuing function of the bank. On the European continent banking generally means discounting bills of exchange even of such low denominations as five francs. Banking adapts itself to the industrial progress of the country, satisfying the industrialists' different needs by different means. Hence, argues Moulton, "it is impossible to give a precise definition of banking for the reason that at one time or another the most widely differing economic functions or services have been designated by the term. Even now it includes various forms of financial operations on substantially different principles." See "Principles of Money and Banking," p. 3.

formation of an association the members of which will be entitled to style themselves as ' bankers.'[1] Companies conducting business the bulk of which is akin to that of banking business become entitled to the use of the word " bank."

It would be wise then to place adjectival or qualifying epithets indicating the nature of business transacted. Such words as ' Commercial Banks,' ' Exchange Banks,' ' Savings Banks,' ' Investment Banks,' ' Mortgage Banks,' ' Agricultural Banks ' and ' Industrial Banks' are more significant, vivid and clarified.

## The Futility of any Definition.

The most cogent reason why any attempt to define a " bank " should be given up, lies in the fact that an institution or individual need not be a bank or banker and yet perform banking business. The Loan and Trust companies of the U.S.A., though designed for specific purposes, have encroached on the banks' sphere

[1] In Copland *vs.* Davies (1872), 5 H. L. 358, Lord Hatherby defines legitimate banking business somewhat in the following manner : " Lending money on short accommodations as against permanent or long-term loans, discounting of bills of exchange payable within not more than six months, issuing of drafts, letters of credit, circular notes, accepting bills on behalf of customers which are drawn on the security of letters of credit, receiving of deposits, and current accounts and honouring cheques drawn on them, receiving deposits and current accounts and of valuables and security in safe custody and collecting dividends and interests on the latter, acting for customers in all matters of finance usual with bankers, buying and selling stock exchange securities on behalf of customers, making periodical payments for customers, to clubs, charity funds, life companies, etc."—Quoted by S. R. Davar in " the Law and Practice of Banking."

of work and to-day they stand as the most [1] formidable rivals of the American banks. Their desire to earn more profits has led them to invade the field of banking.

Again, in several countries, the private bankers who do not subject themselves to any official regulations pursue an elementary form of banking business in addition to other and more lucrative forms of business. But the main defect of this kind of banking business is that the depositors of the private bankers stand to lose their money if the private banker suffers on account of his outside activities. In India the indigenous banker very often combines banking business with trading. To him banking business is one of the various means of employing his money. Banking, agency, commission, brokerage, and middleman's profits are some of the various avenues for earning money. The same is the case of the German private bankers.[2] Country banking in almost all the countries of the world is admittedly of a mixed nature. The big private banks of France go by the name of "La Haute Banque" and these perform banking business somewhat closely resembling that of the "merchant bankers" of London.

[1] The Guarantee Trust Company of New York besides performing banking business of every description established itself in Constantinople and started a Clearing House to enable the different banks to conduct their operations with ease and efficiency. In 1922 its business was ceded to the Ionian Bank which had to close its business in 1928 as a result of the difficulties placed by the Nationalist Government of Turkey. The Deutsche Bank is now running this branch. See the "Statist," p. 713 (1930).

[2] See Dr. Schmidt, "The German Bank Inquiry," 1908-09, p. 249. See also "Keith Le Cheminant," "Colonial and Foreign Banking Systems," p. 17.

## Section II.

### Functions of Different Types of Banks.

Discarding the difficult task to define the word 'bank' it remains to take up each particular type of bank and proceed with a detailed study of its operations.

### The Commercial Bank.

The commercial bank is but one type of banking institution. As its very name indicates, its paramount duty is to collect the floating capital of the community into its hands and finance the temporary needs of commercial transactions. As deposits are purely demand obligations, orthodox theory forbids the granting of long-term loans with these short-dated deposits. The commercial bank's function is not to make permanent loans and provide capital for investment purposes. Nor is it its duty to furnish the whole fixed capital for trading purposes, but it can supply as much as is occasionally needed for carrying on business or making investments in it.[1] A commercial

[1] Adam Smith says: "What a bank can with propriety advance to a merchant or undertaker of any kind is not either the whole capital with which he trades or even any considerable part of that capital, but that part of it only which he would otherwise be obliged to keep by him unemployed and in ready money for answering occasional demands."—"Wealth of Nations," 1893 edition, p. 231.

British and Canadian banks generally do not undertake investment business and German and French banks undertake investment banking also in order to help their clientele in the matter of investing their surpluses. American banks have pursued the latter course and they are setting up the cry that there should be a rediscounting agency for their investment assets. See the "American Banking Crisis," by Bogen and Nadlar, p. 196.

bank should differentiate a genuine borrower from a speculative investor. It has to encourage the genuine borrower and take care of the *bona-fide* businessman. As the depositor is liable to make a call on his money at any time the commercial bank has to employ it in self-liquidating and rapidly-maturing loans or convert it into such other assets which not only lie within his quick and easy control but may be converted into standard metallic money with the minimum of risk attendant on such a conversion. The commercial banker should not be a 'risk-bearer,' willing to take chances along with other businessmen engaged in the development of new industries and manufacturing enterprises.

This is all theory proper but coming to actualities one finds the oft-designated 'commercial banks' making loans for investment purposes, creating fixed capital, helping speculators who dabble on the stock exchange and granting loans to persons for purely consumptive purposes. Thus commercial banks are only commercial in name and they usually perform such functions which are beyond their legitimate scope and province.

In Germany and France the banking institutions are partly commercial banks, partly syndicating and promoting concerns. As the London *Economist* puts it "the German banks.....are stock, bill and exchange brokers, banker merchants, trust, financial and promoting concerns, etc." Lord Inchcape styles the German banks as "Clearing banks, acceptance houses, issuing houses, discount

companies, promoting syndicates, traders and bankers." [1]

The same is the case with America. H. G. Moulton aptly says that the " greatest problems of banking organisation and control have arisen on account of this confusion of investment and commercial operations." This self-same opinion is repeated by all recent observers. M. L. Stoddard says that no banking reform is so important as that of preventing commercial banks from undertaking investment banking operations. The formation of banking affiliates to conduct investment banking is also condemned by Dr. H. P. Wills.[2] According to C. A. Conant," the neglect of the fundamental distinction between commercial operations and other banking operations and the fond indulging of the commercial banks in other than commercial operations has led to commercial crises."

[1] The influence of the German banks on industry can be understood from the following quotation : " The men who direct the German banks are all the time in close touch with the iron and coal industries, the manufacturing and trading classes and the ocean steamlines. With them finance, industry and transportation go hand in hand and are regarded as integral parts of the same problem. The German banker has a finger in everything that is going on. He is represented directly or indirectly on the boards of manufacturing, trading, shipping and mining companies. He has his eye on all the staple markets. The bourse is an essential part of his domain. Underwriting is one of his recognised functions and Germany is thereby spared many of the scandals of the British Company promoting." See the " London Banker's Magazine," July, 1906.

In France " *Banks de affairs* " carry on banking business very closely allied to industry. the *establishments de credit* conduct commercial banking business on the lines of the English Joint Stock banks.

[2] See also my article " Central Banks and Speculation," " Calcutta Review," October, 1932.

Fortunately for India, the Joint Stock banks find ample scope for financing the internal trade of our country. The growth of industrial concerns is quite a recent feature and joint-stock banking is yet in its infancy ; so, such acute problems of banking organisation or evils arising out of a misuse of funds have not appeared in this country.

## Exchange Bank.

An Exchange bank can be defined as a dealer carrying on business in one or more countries undertaking in each to buy and sell credits in others. Anybody who wishes to sell a bill or cheque or other credit instruments payable abroad in another country can get this done at the hands of the exchange banker. He likewise stands ready to sell the needed credit instruments in the foreign centre to those who might have obligations to pay there. The usual concern of the exchange banks is to finance the foreign trade of a country and do other incidental duties in connection with the financing of foreign trade. Their primary duty is to purchase the bills of exchange that arise in the process of export and import business of a country and deal in exchange. They liquidate the international indebtedness by exporting or importing precious metals and securities. This gives them scope to handle gold and silver bullion. They buy bills in the market and deposit them with their banking correspondents in London, New York, Paris and other monetary centres. They draw and sell their own drafts on these deposit accounts. They establish balances abroad and

sell them for more than it has cost them to accumulate there. As they sell their own drafts against their balances abroad and as they create the right to draw upon the foreign balance for a given amount, they have to replenish their balances as soon as they drop to a certain minimum. It is always a wise policy to cover every obligation with assets payable in the same place and in the same currency. But if balances in some centres are too high or too low the exchange bank negotiates with other banks or foreign exchange dealers who are placed in the contrary position. But if all the exchange banks and dealers have as a body too high or too low balances, the remedy lies in adjusting the price, *viz.*, lowering the price of currency of which too much is held and raising that of which too little is held. The price is generally quoted in terms of currencies of other centres.

Exchange banks which are generally anxious to sell their own drafts make it a policy to remit money to make their account good. This credit will provide merchants and others who have to make remittances abroad with the necessary means to do so. By their policy of forward contracts the exchange banks tend to mitigate unnecessary oscillations in the exchange value of their countries' currencies. India has been fortunate to procure the services of expert institutions which specialise solely in exchange business and conduct ordinary banking business, loans, overdrafts, and discounts only if funds permit.

In England, the U. S. A., and the European continent the commercial banks deal in foreign exchange

usiness also. Banking theory emphasizes that the exchange banks should have large capital of their own. Expert and skilful handling of this intricate business has also been advocated. Practice has demonstrated that exchange business is quite a profitable one to the banks and that very little risk attends this kind of business now. With the advent of the exchange standard system a regular artificial and effective par of exchange, as it were, is created and the speculative element which hitherto characterised the exchange relations between the gold and silver-using countries has thus been removed to a great extent.

## Savings Banks.

Savings banks are thrift-promoting concerns. Their avowed object is to collect small sums of capital and take care of the temporary surplus of the depositors. They pool the different resources and make the sum available to large-scale borrowers engaged in industry or lend their money on real estate mortgages and for capital investment purposes. Their choice in making loans is generally limited by law to the safest and best securities. The customers' deposits that flow in generally exceed possible withdrawals, hence they do not and need not maintain handsome reserves. The customers' deposits, generally speaking, are *bona-fide* deposits remaining for a long time in the hands of savings banks. Hence they consider that it is not so important to keep their assets in liquid form, make short-term loans and hold cash as the commercial banks have to do with their short-term deposits which

might be called upon at any time by their depositors. There is a bewildering multiplicity of savings banks of different kinds in the United States of America. The different kinds are stock, mutual and guarantee savings banks. The stock savings bank is formed by shareholders whose capital and reserve act as protection to the depositors. The profits are divided among the shareholders. Mutual trustee savings banks are conducted by trustees who receive no pay for their service. The earnings here are paid to depositors after adding to the reserve. The mutual type is modified by the acceptance of special deposits which act as a guarantee fund for the ordinary deposits and in return get the earnings above the stipulated rate paid to depositors. In England the trustee savings banks became the subject of much discussion and several laws regulating their business have been passed. But they have been overshadowed a long time back by the Post Office savings banks. In India the commercial banks have a savings branch department attached to them. The Post Office manages the Government savings banks. The money collected by the Postal Savings Department is spent by the Government of India for its capital expenditure or sometimes even for its ordinary expenditure. The customers' deposit money constitutes a floating charge on the credit of the Government of India. No special reserves are maintained.

## Investment Banks.

Investment banks or Trust or Finance companies, as they are known in England and America, consider it

their duty to mobilise funds and duly apportion them to productive uses. They are " financial undertakers " whose avowed mission is to control the distribution of capital into several uses. Messrs. Willis and Bogen [1] say that in its primitive form investment banking involved a loan of the capital of the investment banker or that of a few clients on a long-term basis to some sovereign. In the second stage the investment banker buys the stock and bonds of Governments and corporations which desire capital. He resells their obligations to others. The third step in investment banking consists in selling its own obligations to investors advancing the proceeds to them who can utilise the capital. The mortgage bank is an example of such an institution. The essence of investment banking is the purchase of security issues and their subsequent sale at a profit to investors.

The capital equipment for industry and Government is furnished generally by loans under the guidance of these investment companies. They act as a link between the borrowing entrepreneur and the primary saver of capital. As productive processes are becoming more and more highly specialised the need for capital is being felt and the investment banks have chosen the special task of aggregating funds and lending them for long-term purposes. These banks are however cautious in attracting long-dated deposits and have usually large paid-up capital of their own which they can afford to lock-up in assets which are more lucrative but less easily realisable than commercial

[1] See H. P. Willis and J. T. Bogen, " Investment Banking."

paper. They accept loans from the public and repay them at the end of 20 or 30 years and these are known as debentures. Generally speaking the debentures they float seldom exceed their share capital and these constitute a floating charge on the assets of the company. The matter of their investment is left to the choice and will of the investment banks. The rate of interest they pay generally is low and makes possible the distribution of dividend on share-capital. They generally invest their resources in various industrial companies, railways and mills. Provided they adhere to the principle of wise distribution of risks there is no reason why they should fail.[1] Usually the articles of association limit its individual investments in any single undertaking to about 5% of its total funds. Another safeguard which conduces to their success is the proper provision for decent reserves as a likely contingency against the depreciation of its securities. Experts usually guide these investment banks in the choice of their particular securities. Unlike industrial banks they do not associate themselves with the industrial companies and participate in their management. In Germany these finance companies control the industries promoted by them.[2]

The purposes for which these investment trusts are started are very numerous. These investment companies, which confine their business to the domestic field only, generally perform the following duties of investing funds :—discounting bills, lending on approved

[1] See Mead, "Corporation Finance," 6th Edition, pp. 195-203.
[2] See D. H. Robertson, "Control of Industry," pp. 81-83.

securities on mortgage of land, house and shop property, assisting commercial undertakings, underwriting issues of securities, converting business into joint-stock companies, receiving deposits, purchasing assets of insolvent estates, and carrying on business as trustees and agents. Those investment companies which extend their operations abroad, undertake such varied functions as investing in the securities of the U. S. A., in Canadian real estate mortgages, railways bonds, telegraph companies, rubber, tea and coffee plantations, lending to mining companies, carrying on banking business, lending money to the prospective investors and holding their deposits in their own lands, developing industrial business in Mexico, promoting rubber companies, employing capital in South Africa, issuing and promoting financial undertakings acting as issue houses for Government and other loans, acquiring free-hold land, working railways, providing organisations for converting stocks into more than one class of security, financing a prospecting company, carrying general financial business and acting as agents and trustees.[1] Thus investment banks are

1 The Investment trust organised under the Edge Act was specially meant to intervene in the exchange market. "It takes over long-term securities of foreign borrowers who desire to establish a credit in the U.S.A. for the purchase of American goods ; against these as collateral it issues debentures to Amercian investors. It uses funds secured in this manner to take up the bills of exporters whose products the foreign borrowers wish to obtain. Money-lenders are thus indirectly made to purchase the export bills of the country by a roundabout process. National banks can co-operate in forming Investment trusts by subscribing not more than 5 per cent. of their capital and surplus. These would be useful in financing a favourable balance of trade

considered as the recognised intermediaries in the raising of funds for fixed capital purposes.[1]

The investment banker issues his own bulletins and circulars to advise his clients in the matter of purchase of investments.[2] Besides increasing the productivity of capital by letting it flow into remunerative channels they perform excellent social services. Sir R. Giffen says, " In addition to construction work in developing, starting and aiding the joint-stock companies, they undertake ' salvage work.' They take over the assets of failed companies or undertake to restore to order all companies labouring under difficulties."[3]

## Mortgage Banks.

Mortgage banks try to create negotiable bonds out of real estate—be it agricultural or urban housing and business property. Bills, cheques, and notes are *par excellence* the best negotiable instruments endowed with the utmost degree of transferability. Real estate such as houses and land are not easily transferable and many formalities imposed by civil legislation have to be complied with before real estate can be made to pass from hand to hand. Mortgage banks render this unnecessary by creating blocks of securities

1 *Vide* F. Lavington, " The Capital Market," p. 119.

2 A. S. Dewing says, " Investment bankers serve as a kind of balance wheel between the optimistic psychology of the promoters of corporations and the credulous psychology of investors. Their duty is to act as conservative buffers between the promoters of corporations and the would-be buyers of the stock."—" Financial Policy of Corporation," p. 28.

3 *Vide* E. T. Powell, " Mechanism of the City," Ch. I.

out of real estate and placing them in the market for investment. These are easily purchased by people requiring a safe and steady long-term investment. As land values do not fluctuate to a great extent European mortgage banks are doing quite a flourishing business.

The Credit Foncier of France,[1] the "mother of all mortgage banks," the German Hypothekenbanken, the Mortgage Bank of Spain, the Mortgage Bank of Austria-Hungary are all thriving institutions. The recently created Renten-bank has been converted into an agricultural bank for financing long-term credit needs of the German agriculturists. In the U. S. A. both joint-stock land mortgage banks and federal farm land banks have perfected the business of mortgage banking and a special mortgage bond exchange has been recently established. Almost all economically poor countries are hastening to develop this type of institution to facilitate their economic development specially in the field of agriculture.

So long as a sound evaluation of land and due limitation of loans to half the appraised value of the land is

[1] This was founded in 1852 along with the Credit Mobiliere. The Credit Mobiliere is free from Government control and it finances industrial and financial enterprises. The Credit Foncier finances agriculture. It is supervised by the French Government. It is the important mortgage bond company lending on land situated in France. It borrows from the public at 3 per cent. against its debentures and it lends to municipalities, landlords, and others at about 4 per cent. for periods ranging to 25 years. Although its main purpose was to aid agriculture it makes twenty-two loans in the city for every single loan made in the country. This perhaps is due to the fact that the trouble and expense of the operations are lower in the city than in the country. See M. T. Herrick, "Rural Credit."

scrupulously followed there is no reason why a mortgage bank ought to fail. Frequent appraisals, examinations of title and supervision of insurance policies are the essential requisites. A mortgage bank should have no other form of obligations than mortgage bonds. The mixed mortgage bank lending for short- as well as long-term periods is becoming rarer and rarer. The Weehsel-bank and the Bayrische Hypotheken are the only remaining examples of mixed mortgage banks in South Germany. A mortgage bank is not necessarily limited in its operations by the amount of its capital. The loans that it can make depend on the bonds (*bons hypothecaris*) that it can float and sell to the public. These loans are usually granted for introducing diversified farming, for making improvements in land and for pursuing scientific agriculture, and due care is exercised that land does not deteriorate in value while the borrower is making his amortisation payments. Mortgage banks enable the urban or rural borrowers to obtain loans at a low rate and thus confer a great boon on them. They confer a similar blessing on society by creating safe, sound, easily marketable and standardised bonds for investment which easily comply with the requirements of commercial law. Working under close Government supervision [1] they promise a steady and fixed rate of return. Many local authorities float the communal loans through the agency of the mortgage banks.

1 See J. L. Cohen, "The Mortgage Bank," pp. 10 to 24.

## Co-operative Credit Banks.

If long-term credit is supplied by the land mortgage, the short-term credit for agricultural purposes is supplied by the rural co-operative credit societies. Both the rural co-operative credit societies and the land mortgage banks fall into the broad category of agricultural banks. These are created with a view to knock down the high and usurious rate of the money-lending Shylocks, or "Loan sharks" as Americans style them, who practically exploit the agriculturists according to the urgency of their needs. Besides combating this vicious monopoly of the usurer they tend to promote thrift, encourage industry and train members in the art of self-government. Based on the principles of equality and democracy they enable people to realise the value of co-operation and encourage its extension to other fields of social activity. Pooling their joint resources and on the strength of unlimited personal liability they borrow loans in the money market which they distribute to the members for productive purposes at a low rate of interest. Loans are usually repaid by monthly instalments and are secured by promissory notes of members which with two or more endorsements of co-members form the basis of their loans. This system has been rightly termed the "*capitalisation of honesty.*" Personal security is converted into marketable collateral for loans on a great scale and as Leon Say puts it, it is "credit in the most advanced form." Germany was the pioneer in this line of banking and to-day a large number of

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these credit societies exist in India, Canada, the Continent of Europe and the United States of America.

## Industrial Banks.

Industrial banks consider it their bounden duty to help the entrepreneurs of society with capital required for the purposes of production on the strength of industrial security they possess.[1] This security is not of a sufficiently liquid character to tempt the commercial banks to loan out their money; besides it would be hazarding a great risk to attempt to finance long-term loans with their short-dated deposits. These industrial banks usually have industrial experts to advise them on the business propositions of their clients and on the strength of their advice loans are granted. These banks very often exercise effective control over the industrial companies financed by them by having their representatives included in the directorate of these companies. The Deutsche Bank of Germany might be considered as a typical mixed bank devoted towards the financing of industries.[2] The Credit Lyonnais of France similarly undertakes industrial banking to a large extent.[3] The Societe Generale

[1] See the Report of the Macmillan Enquiry Committee for the functions of an industrial bank, p. 172.

[2] For a further understanding of the subject, see P. Barrett Whale, "Joint-stock Banking in Germany." See also Dr. Goldschmidt's evidence before the Macmillan Committee.—Committee's Report, p. 163.

[3] Special Industrial banks such as L'union des Mines finance different industries.

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of Belgium can be considered as the first " mixed bank " having a definite bias towards industrial financing and close control over industrial concerns in which it has financial interest. The " Big Five" of Belgium follow this policy at the present day.[1] The Trust Banks of Switzerland [2] issue their bonds and grant long-term loans out of the proceeds to industrial enterprises. The banks of Sweden play the rôle of financial middlemen between the entrepreneurs and the savers of capital.[3] The Industrial Bank of Japan which was started in 1902 finances industries. It undertakes to attract long-term deposits but relies to a large extent on its power to float debentures and the deposits it secures from the Deposit Bureau.[4] These industrial banks do a great service to society by financing such productive industries as are needed and help all thriving concerns that may occasionally need capital by supplying it at the proper time. Besides they assist the promoters to float and organise new industrial companies and underwrite their shares. They are machineries meant to provide the necessary capital equipment and incidentally help the rational management of industry.

[1] See " Colonial and Foreign Banking Systems " by le Cheminant.

[2] See S. E. Thomas, " British Banks and the Finance of Industry," p. 106. See also Memorandum on Commercial Banks, 1913-1929, Geneva, p. 262.

[3] See the article of Dr. Sven Brisman entitled " The Swedish Banking System " published in the *Times Engineering Supplement*, dated 12th April, 1930.

[4] See H. M. Braetter, " Japanese Banking," U. S. Department of Commerce (1931), Trade Promotion Series, No. 116, p. 181.

India has not deliberately copied any country's model in the matter of industrial finance. An All-India Industrial Corporation and a Provincial Industrial Bank in the industrialised provinces are long overdue. Without them the successful ingredients of industrial financing, *viz.*, a low rate of interest and an adequate examination of industrial securities possessed by borrowers cannot be had.

## Labour Banks.

American Trade Unions have started Labour banks and the pooling of the labourers' savings is secured through this agency. The one distinguishing feature of these labour banks is the fact that they are run in the interest of the depositors, for the stockholders get only 10%. Out of the remainder of the profits the depositors get a slice of the cake. No one considers these labour banks as mushroom growths.[1] Prudently managed they can teach the savers the sound principles of investment and perform real service to the community. It might be that their aim to buy out capitalistic organisations and carry on industrial ownership on the basis of Trade-Union ownership might not succeed. But so long as they act in co-operation with the co-operative banking organisation of their country the real interests of the workers would be realised.[2]

[1] The labour banks of the Brotherhood of Locomotive Engineers, the Brotherhood of Railway Clerks, the Order of the Railroad Telegraphers are well-established and several labour banks are doing banking business in Minneapolis, Los Angeles, and other States.

[2] See N. Barou, "Co-operative Banking," pp. 93 and 94.

Although the operations of the specialising banking concerns have been outlined in detail it should be borne in mind that no such logical and clean-cut specialisation exists in actual every-day practice. Instead of increasing financial specialisation, integration seems to be the accepted feature of the financial mechanism of the different countries. These different types of credit institutions constitute the whole financial network that can be spread over the community. Its efficiency depends on the intimate inter-relationship and close inter-dependence of these separate institutions. These are but different cogs in the single financial wheel and all these separate institutions work harmoniously as if the financial mechanism is a simple clockwork. The endeavour of this financial mechanism is always to be on the look-out to satisfy the genuine economic and geographic needs of the country. But from the standpoint of pure banking considerations this systematic study of the work of the different kinds of banks will have its own justification.

## Section III.

### The Economic Services of Commercial Banks.

*The Man in the Street.*

Ask the man in the street who is ignorant of the definition of a " bank " what a bank does and the unedifying answer is that banks are vast storehouses of money. His attention is more rivetted on the " Parawalla " mounting guard over the banks' vaults

with the lynx eye of a dragon. He hardly realises anything further.

### Businessman's View of Banking.

A businessman possessing a banking account would furnish more accurate information. He relates how the bank takes care of his money thus reducing his risks from theft or fire. He says he is saved the trouble of counting out money and paying it across his counter thus wasting his precious time. He says that his bank acts as his clearing office for the stream of payments coming in and going out.[1] He will proceed further and relate how the bank very often enables him to overdraw his account and that all money that is to be paid to him is collected by the banker. He speaks of the facilities for keeping his accounts in a thoroughly businesslike manner, for the bank becomes his ledger-keeper faithfully recording all payments. Lastly he says he can make a ready reference to his banker to establish his own financial stability and he does not fail to eulogise the banking facilities in the matter of foreign remittances he may have occasion to make.

### The Economists' Conception of Banking.

However it is the economist who furnishes the most enlightened answer. The banks economise the use of

1 Dr. H. W. Steiner aptly says, "The banker is the book-keeper and clearing agent of society." He does a species of social clearing of current debits and credits of the rural constituent business enterprises. There is a coalescence of capital supply and currency system in commercial banking. The banker is a borrower of credit who keeps the record himself.

money to a great extent by creating inexpensive instruments of exchange which reduce the cost and effort of exchange. The banks gather up idle money and invest it in profitable employment thereby rendering signal service to the cause of trade and industry. With the help of the banks easily marketable wealth of every sort can be converted into easily available purchasing power. Even the mere anticipation of goods on future wealth can be converted into cash which can be utilised to conduct industrial business operations to produce those very goods.

## Economic Bridge.

Banks give admirable scope to talented men possessing integrity and knowledge to fructify their business ideas by combining them with "other peoples' money." Banks provide the necessary sinews of war for the business and make possible the realisation of their business ideas. The tiny streamlets of capital flowing into the banks' vaults become rivers and these rivers fall into the vast ocean of national finance. It is distributed among the several industries quickly and a very rapid utilisation of capital is made by the banks. They moreover distribute it according to the relative needs of time and space. As Walter Bagehot says, 'The banks are a sort of standing brokers between the quiet saving districts of the country and the active employing districts.'

## Expert Financial Advice.

Banks become the financial partners of their clients and furnish them with expert advice. The banks perform a silent and ceaseless censorship of their customers' accounts. Within the scope of law prohibiting fraud and theft and subject to the limits of conscience, the bankers and their confreres can dictate outside the boundaries of their own province. As J. W. Gilbart says, " There is many a man who would be deterred from dishonesty by the mere frown of a banker though he might care little for the admonition of a bishop."[1]

## Promotion of Thrift and Business Virtues.

The possession of a bank account stimulates thrift, economy and ambition on the part of its possessor. A bank account endows a man with moral dignity and confers some moral status on him in society. Modern banks have a trust-creating power and inspire people with faith and confidence. The establishment of sound banking business has altered for the better the character of large sections of the population in almost all countries. Hence Lecky long ago remarked that " credit is a great moralising influence of society by the immense importance it has bestowed on character."[2] The test of economic progress and material advancement lies in the development and successful functioning of the credit mechanism.

1 J. W. Gilbart, " Logic of Banking," p. 117.

2 W. H. Lecky's, " Essays on Rationalism," p. 348.

### Stimulus to Productive Activity.

The banker is not an ordinary middleman seeking for profits. He is gifted with imagination which enables him to realise the distant future. He is empowered with advisory, directive and discriminatory capacity. Realising his duties to both the saver and user of capital he stimulates production and increases the well-being of the nation. It is indeed a truism to assert that "banking accommodation stimulates production and increases consumption."

### Nerve-centre of Modern Business World.

The importance of banks to modern civilised societies can well be understood from the extent and variety of the services they render to them. Banking and credit according to Bishop Berkeley are the Philosopher's Stone. An inadequacy of banking facilities seriously restricts all industrial and commercial operations. The bank is "the nerve-centre of the modern world" and its collapse effectively paralyses for an indefinite length of time the entire economic organisation of society. Economic chaos and economic prostration leading to the gradual impoverishment of the country would be the result. The real economic aftermath resulting out of the collapse of the banking system can be seen in shrinking production, declining values, lessening number of exchanges, business depression and a reduction of the value of trade. This would not lead to the cessation of all economic activity. The real foundations of wealth and the real active producing

capital of the community, namely, land, factories, buildings, workshops, railways, raw materials and mines, would exist. The economic prosperity of a people solely depends on the natural wealth of the country, the industrial character of its inhabitants and a social system possessing excellent disciplinary habits. So long as their special technical capacity for manufactures and special skill in meeting the demands of particular markets exist a new credit system might be raised eventually but during this interregnum industrial peace and economic stability would be endangered.

## Coiner of Moral Virtues.

An efficient banking system on the other hand improves the tone of credit and the business morality of society to such an extent that banks are termed the "coiners of probity, reliability, honesty, integrity and ability." Such virtues as honesty, good faith, the encouragement of sound principles and practice that engrain into the character of a nation and the sanctity of implied contracts are better impressed under a highly complex credit system than in the simple monetary system. The spread of national prosperity in the last century is mainly attributable to the widespread and thorough organisation of the banking business under wise and far-sighted control of sound and conservative bankers.[1]

1 "The prosperity of the United Kingdom is chiefly due to its banks financing manufacturing industries and if manufacturing industries had not been developed by the banks, the population would have been only 15 millions instead of 44 millions as at present, because the United Kingdom would have been able to support 15 millions alone on a self-supporting basis."—*The Daily News.* See also Sir J. A. R. Marriot's "Economics and Ethics," p. 79.

## Governing Arbiter of Industrial Organisation.

A bank is not merely an organisation in economy. It is a power-realising energy which stimulates the accumulated resources in industry of a large number of people. The bank plays a decisive part in the determination of outlay, investment and capitalisation. It plays the rôle of a governor exercising beneficent influence and directs authority over the industrialists financed by it. J. A. Hobson says, " General finance is the governor of the economic engine. It distributes economic power among the various industries allocating the capital of the saving classes to road-making, irrigation, mining, the equipment of new cities, the establishment of staple manufactures and the supply of financial resources for various purposes of Government. The finest business instincts, the most rapid, accurate and complex powers of inference and prophecy, the best balance of audacity and action, the largest and the best informed imagination are needed for the work of general finance."[1] In the management of their discounts and of their reserve, the bank has the power to coerce them to do what they ought to do anyhow but might not, if the bank were not brought to contact with them. A mere intimation that loans would be withheld for aiding the working capital would be sufficient to force a business or industrial concern into the adoption of almost any policy of re-organisation, retrenchment, expansion or any other action which the banks may desire. This influence the banks are expected to exert while financing industry and enterprise.

[1] Work and Wealth, p. 57.

They ought to select the good and weed out the bad and give life to the favoured industries and take out life from the bad ones.

### Active Economic Intermediary.

A bank is a useful and prominent institution in the modern economic organisation of society. To its help and promotion is chiefly due the progress that has been achieved in industrial life. A well-conducted bank [1] whose functions include underwriting, dealing in stocks and bonds, gathering funds from business enterprises and large corporations both at home and abroad would be conferring inestimable benefit on society.

The dominant influence of a commercial bank is not to be felt in the field of industrial production alone. Wholesaling, retailing, transportation and all other phases of economic activity which are dependent on borrowed funds are subject to the influence of these institutions. The modern world is essentially an industrial world and the smooth progress of each nation's industries is ultimately dependent on the pecuniary aid of the bankers.

### Arbiter of Industrial Organisation.

The avowed object of modern industry is to transform the resources of nature through human and mechanical effort into services and commodities for the

1 On the Continent of Europe the word 'bank' is broader in its significance and its business includes underwriting, selling stocks, and bonds and many other kinds of financial operations. *Vide* Maurice Patron, "The Bank of France," p. 51.

consumption of humanity. Agriculture, fishing, lumbering, mining, manufacturing, transportation and communication, transmission of light, water and power and the construction of public works of various kinds are but different aspects of modern industry. Modern industrial production is a roundabout process involving time and capital. It consists in the getting together of the necessary real capital, labour and raw materials. Production has to pass through several stages and infinite series of processes before the finished product can be obtained. During this elaborate process requiring the handling of raw materials through several stages, wages have to be paid to the labourers and machinery replaced as it gets worn out. The factory building has to be kept in good condition and if business were really to expand all the necessary equipment would have to be increased. As these industries conduct their business on a 'narrow margin' and as these different items involve funds and renewed borrowing they obtain credit from the banks. The banks continuously provide the necessary credit to carry on production on a large scale. Modern industry has become international mainly through the influence of the banks. Hence Norman Angell (now Sir) says, "Wealth in the economically civilised world is founded on credit and commercial contract." [1]

## Banker as Intermediary.

Modern economic society is composed of different economic groups or units such as the extractive group

[1] Norman Angell, "The Great Illusion," p. vi.

dealing with the obtaining of wealth from the farm, the mine and the forest ; the manufacturing group converting these extracted goods into finished or semi-finished goods in factories, mills and workshops ; the transporting group carrying them from place to place by means of railroads and ships ; the merchandise group storing them in shops for distributing goods to the ultimate consumers ; the financial group handling the money and credit in banks, loan associations and credit houses and, lastly, the service-performing agencies rendering direct services to people in the school room, music hall and hospital. While these different groups specialise in their different duties they associate together into a " hive of related social activity " or one functional mechanism.[1] The intermediary between these various groups in the economic world is the banker. He provides the credit and formulates the decisions upon which the economic well-being of the producers, wage-earners and the nation depends. Using " other peoples' money " entrusted to them in the shape of saving banks' deposits they obtain a strategic, dominating and dictating hold over the property of the producers and manufacturers. Hence the banker is often styled as the ' arbiter of the economic destiny of a nation.'

### Banking is tending to become international.

Modern banks exhibit some kind of international co-operation. Every great London bank acts as the agent for about a hundred foreign banks in all parts of

[1] J. A. Hobson, " The Industrial System."

the world. There are British banks outside the Empire, in the Levant, in China, Japan and the Dutch East Indies and all over South America.[1] The reconstruction of the Colonial Bank under the new designation—Barclay's Bank (Dominion, Colonial and Overseas) aims to secure inter-Empire financing. It aims to secure a consolidation of banking interests over the greater part of the African Continent and the West Indian Colonies. Mr. F. E. Goodenough says, 'A cheap inter-Empire finance and good organisation is better than actual tariff preferences in securing Imperial Development.'[2] The great German banks always worked in conjunction with subsidiary banks and by part control of foreign banks.[3] This feature is to be exhibited in the French-American Banking Corporation which includes the Comptoir National d'Escompte, the National Commerce Bank of New York and the First National Bank of Boston. Some agreements are entered into between banks doing business in different financial centres. There is J. P. Morgan & Co. of

[1] Details of their branches, etc., can be obtained in the banking number of the *Economist* and the *Statist*.

[2] See his speech to the shareholders of the Barclay's Bank, January 21st, 1925. See also the *Times of London*, August 20th, 1925.

[3] The Disconto-Gesselschafte obtained stock in the Campaigne Commercial Belge of Antwerp; the National Bank for Deutschland obtained shares in the Credit Italiano and supplied capital for the Credit Mobiliere Francaise of Paris. The Banca Commercial Italiana was founded by the joint co-operation of the Four D's of Germany. A large part of Italian industries were solely financed by the German Banks. In the electrical industry about £25 millions more were invested by the German banks alone. For the present-day position of German overseas banks, see the Memorandum of the League of Nations on Commercial Banks.

New York which works closely with Morgan, Greenfell & Co. of London and Morgan, Harjes & Co. of Paris. Similarly there is Lazard Freres et Cie of Paris as well as Lazard Bros. of London. So also J. and W. Seligman & Co. of New York works in harmony with Seligman Bros. of London and Seligman Freres et Cie of Paris. Thus the most distinguishing feature of this century is the close network of these international banking institutions. The main advantage resulting out of their successful working is to establish trading connections with undeveloped countries and it facilitates the investment of capital in the unindustrialised countries thereby increasing the efficiency of production and adding to the size of the National Dividend. It would enable the industrialists and manufacturers of the country to undertake the supply of foreign orders only if the home banks finance such contracts even though they are generally of a long-term nature. In a similar manner the French banks[1] are seeking to control the

[1] The Banque de Paris et des pays-Bas, the Societe Generale and the Credit Lyonnais follow this policy. For instance Mr. Schneider, head of the Creusot Steel Factory, works mainly through the Banque de'U nion Parisienne and the Credit Lyonnais who have founded a bank in Czhecko-Slovakia called the European Industrial and Financial Union which has the controlling interests in the Zinovestaka Bank and enjoys the diplomatic protection of the French Government. "M. Schneider has virtually secured control over the textile, sugar, the manufacture of alcohol, the steel and metal industries and Skoda Munition Works. He has recently acquired interests in the oil, electrical, power, coal, chemical products, agricultural machinery and even life insurance, the collection and distribution of milk and the manufacture of soaps and candles business."—*The Daily Herald* Article on the Stinnes of France by George Slocomb.

working policy of the foreign banks.[1] The French banks have exerted their control only in the matter of investment rather than of trade in foreign countries.[2]

## Bankers the Servants of the Community.

Modern bankers have realised that they are public service institutions and the servants of the community and the material progress of the country or "the composition and nature of national economy"[3] depends on the promptness with which they discharge their duty and aid their customers in their various undertakings. He lends a helping hand to every progressive movement which promises to benefit the community. If more regular employment, more comfort for the workingman, gradual increase in business turn over and a better general understanding of such intricate financial problems as debts, taxation, and currencies are to be counted, they can only be realised as a result of good banking. Witness, for instance, the co-operation of the British banks with the British Government in the matter of granting guarantees to the British exporters under the Export Credits Guarantee Scheme.[4]

[1] For the general methods of securing this internationalisation see my article "Some Salient Lessons from Recent Happenings in Foreign Banking Systems," January, 1931, *Indian Journal of Economics*.

[2] See the section on "Investments."

[3] See Dr. Jacob Goldschmidt's evidence before the Macmillan Committee, p. 148, Vol. II.

[4] See W. J. Weston, "Economics of the English Banking System," p. 18.

# CHAPTER II.

*Section I.*—English Banking usage—"Other people's money"—adequate cash reserves—different departments.

*Section II.*—Mute record—explanation of different items—demand liability—contingent liability—reserve liability—cash reserve—nature and quality of the investments.

## Section I.

### The Study of a Commercial Bank and its Theory.

*Commercial Banking Theory in a Nutshell.*

English banking literature limits the word 'bank' to a 'Commercial bank.' Practice has consecrated this usage. The word "bank" without a qualifying epithet means a commercial bank. Commercial banks are so numerous that a detailed study of their operations is justified.

Commercial banking arose out of the discovery that money that is deposited by several people is not demanded by all of them at the same time. The goldsmiths of England in the time of the early Stuarts became the depositaries of the valuables and floating cash of the people. Realising that the whole of the money was never demanded by the depositors they began to lend it and these were the true germs of the modern English Banks.[1] Their 'cash

[1] Banks arose on account of the dishonesty of the early bankers, says Dr. Lewis while speaking of the origin of the Bank of Venice. Dr. A. Andreades quotes this with approval and says that the Bank of England arose as the early goldsmith bankers were dishonest. See also R. D. Richards, The Pioneers of Banking in England, "*Economic Journal*," History Supplement, January, 1929.

receipts' were the early progenitors of modern bank notes.

Commercial banking can be carried on successfully with other's capital provided an adequate cash reserve is kept for the prompt payment of all demand obligations.

The most successful banker is he who keeps just enough cash reserve to meet his liabilities and employs the remaining capital entrusted to his care in profitable transactions which, both from the view point of safety and profit, are bill-discounting, loaning on securities of Stock-Exchange collaterals and investing in gilt-edged securities. This is the theory of commercial banking put in a nutshell.

In practice the smaller banks and the newly started ones may not find enough business for their loanable funds; so they embark on various other kinds of non-banking business. In such a case, it is always prudent to have several departments so as not to mix up these various kinds of business with the legitimate commercial banking operations. It is advisable that only a small proportion of the deposit money should be invested in ultra-commercial operations. It would be wise on their part to attract long-dated deposits or "time deposits." This money can be safely tied up till the stipulated time of payment. These banks should learn how to use their credit effectively and not abuse it.

## Section II.

*An Imaginary Balance Sheet to illustrate the Work of a Commercial Bank.*

| Liabilities. | Assets. |
|---|---|
| Authorised Capital. | Cash at hand. |
| Subscribed Capital. | Cash at bankers. |
| Paid-up Capital. | Call Loans. |
| Reserve Fund. | Bills discounted. |
| Deposits. | Advances. |
| Notes. | Investments. |
| Bills Payable. | Bills receivable as *per contra* (acceptances for which customers are liable). |
| Bills receivable (acceptance on behalf of customers). | Bank Premises and Dead Stock. |
| Profit and Loss Account. | |

### Mute Record.

The balance-sheet is an itemised exhibit of the assets and liabilities of a bank shorn of the wearisome prolixity of all details. It is a mute record of the operations of the bank.

### Explanation.

On the left the liabilities are enumerated and on the right its assets are duly marshalled and a glance at this balance-sheet will reveal the financial position of the bank. By "liabilities" are meant all sums of money which the banker owes to the public as in the case of deposits, and to its shareholders as in the case of the paid-up capital and reserve fund. As deposits will be fluctuating it is a temporary liability while the amount of capital and the reserve fund constitute a permanent liability. The assets represent the property of the bank which is actually in its hands as

in the case of the cash reserve or in the hands of the public who will pay it to the bank in due course.

### Demand Liability and Contingent Liability.

Coming to the side of liabilities, the first item is capital. It is the original fund of the shareholders. It acts as a permanent guarantee fund for depositors, and will be drawn on if necessary to pay the claims of the customers of the bank in case of its failure. Banking capital really helps the bank to adjust various disturbances when money *paid in* is far less than money *paid out* of the bank. It forms an integral feature of the financial structure of the bank. All joint-stock banks get themselves authorised to start with a certain amount of capital known as the authorised, nominal or registered capital paying the prescribed registration fees. Only a part of this amount is issued to the public and is subscribed by it. The whole of the subscribed caiptal is not paid-up at the beginning. A part of it is uncalled capital and of the uncalled capital a certain portion is not "callable" except in the event "of winding up" of the bank and this is maintained as the reserve liability of the shareholders.[1] This practice of leaving a portion of the

[1] A concrete example will illustrate this :—

| | | |
|---|---|---|
| Nominal Capital | ... | Rs. 100,000 (20,000 shares of Rs. 5 each). |
| Issued and subscribed capital | | Rs. 50,000 (10,000 shares of Rs. 5 each). |
| Paid-up Capital | ... | Rs. 25,000 (10,000 shares of Rs. 2-8-0 each) |
| Callable Capital | ... | Rs. 12,500 (10,000 shares of Rs. 1-4-0 each). |
| Reserve Liability (callable in the case of winding-up only.) | | Rs. 12,500 (10,000 shares of Rs. 1-4-0 each). |

In the above instance it is presumed that the whole of the *issued capital* has been subscribed. If only a part is *subscribed*, *issued capital* will be larger and the *subscribed capital* will be *smaller*.

bank share uncalled and maintaining a reserve liability is considered a source of strength to the bank but unless these shares are " widely held " there is no real element of strength to the banking institution and much importance should not be attached to this feature.[1] If it cannot be called in during any emergency period it is no use counting upon it as a valuable bank asset. Moreover it tends to depreciate the value of the paid shares as this risk is attached to them. A large amount of paid-up capital is essential for banking success and however prudently banking business can be conducted the small amount of paid-up capital will virtually set a limit to the amount of banking business that can be conducted with it. A large paid-up capital aided by substantial deposits would enable the bank to follow a policy generous to the borrower. However, the fully paid bank-share is coming into vogue and is becoming a popular investment on the part of the public.

It would not be proper to neglect the present-day tendency of the banks to change their relationship

[1] Most of the English joint-stock banks have this feature of partly paid shares and a certain amount of reserve liability is attached to each share. The Indian joint-stock banks have slavishly copied this model but they must realise the impossibility of transacting a large volume of business with their small paid-up capitals. It would be better to follow the practice of the German banks in this respect. Dr. Reisser reported that the paid-up capital and reserve of the German banks was 45% of its liabilities. In England the proportion was 9% and it sometimes was as low as 7%. See Le Cheminant, " Foreign and Colonial Banking Systems," p. 21. See also J. Sykes, " Amalgamation Movement in English Banking," p. 142.

with the public. Quite recently the National City Bank of New York introduced the innovation of cutting down the par value of the stock to 20 dollars a share so as to make it available to the small investor mainly with the object of securing great price stability and increasing popular contact with the small investors. This policy, however, cannot rightly be adopted in this country, for the small investors do not understand the principles of share-holding. If an endeavour is to be made to secure a trustworthy body of shareholders it would be a better policy to secure capital by shares of high value. A steady accumulation of reserve fund would increase its quotation and this would bring about the desired effect of producing a more concentrated and more trustworthy body of shareholders. The tendency of modern banking is to insist on large capital, concentration of operations, wider services to the public and substantial profits on the bank stock.

*The Reserve Fund* arises out of the practice of setting aside a part of the profits before its actual division among the shareholders of the bank. It may also arise in case fresh shares of the bank are issued at a premium.[1] The reserve fund increases the working capital of the bank. Besides inspiring confidence in

[1] The extra Rs. 100 per share which the shareholders of the Presidency Bank of Madras had to pay for their new shares of the Imperial Bank, went to swell the Reserve Fund. The total money obtained on account of the premium paid amounted to Rs. 15,00,000 and was added to the total Reserve Fund bringing it up to Rs. 372 lakhs.

the minds of its customers it can be locked up with impunity though in remunerative but less easily realisable assets. This will also enable the bank to meet any extraordinary losses it may sustain. It may be utilised to wipe off any loss in case certain assets fail to materialise. During lean years banking dividends can be stabilised by drawing liberally large drafts from the reserve fund. Without such a policy the stability attached to the value of the bank share becomes endangered. This reserve fund should be carefully distinguished from the cash reserve kept by the bank to meet its demand liabilities.[1] Recent banking literature has coined a new phrase "secret or hidden reserve." It indicates the habit of the bank managers to understate the market value of the investments and provide generous depreciation funds for premises and other contingency funds.[2] Even if proper valuation is adopted in the balance-sheet banks pursue the policy of publishing reserves which are just equal to their paid-up capitals. " Hidden reserves " are usually included in the case of the English joint-stock banks in the item "Current deposits and other accounts."

1 While a bank cannot conduct its operations without cash reserve it can or may get on with its operations without a surplus or reserve. One Canadian bank was actually insolvent for 40 years before its actual failure. It was conducting banking operations as it had a cash reserve. See " The Interviews on Banking and Currency System of Canada," " The National Monetary Commission," p. 14.

2 Even the Bank of England does not indicate the value of the site and premises in its balance-sheet. The object of creating these "secret reserves" is to square future business losses without their being disclosed by any changes in the balance-sheet.

*Deposits* [1] consist of cash or titles to cash deposited by the customers. It is the usual practice to divide deposit accounts into 'fixed' deposits payable after a certain time, current accounts that can be drawn on at any time by the customer and savings deposits generally accumulated in the Savings Branch department till they await some profitable use. This item will be discussed more fully in a subsequent chapter.

*Bills payable item* represents bills which the bank has drawn on its branches and agents in other places and sold them for cash to those people who had occasion to remit money. These are to be considered a liability as these bills have to be paid on presentation.

*Acceptances* are bills of exchange which are accepted by the bank and represent paper drawn on their customers, *i.e.*, the bank has promised to pay the bills and the acceptance business is reckoned as a liability. What other items are usually included under the heading "acceptances and endorsements" cannot be stated with any certainty. It depends chiefly on the system of book-keeping and accountancy followed by the bank. Some of the English banks include " forward exchange " contracts here and as every contract is covered by a sale or purchase these are referred to in the ' Contra account.'[2]

*Profits and Loss Account* refers to the sum carried during the course of the year together with the amount of profits brought forward from last year. Out of this

1 The usual expression is "deposits and other accounts" and the "hidden reserves " are kept concealed in this item.

2 See Walter Leaf, " Banking," p. 127.

a dividend is distributed to the shareholders after making due provision for bad and doubtful debts and whatever remains represents the total profits lying in the hands of the bank and these are included in the balance-sheet of the bank. Liabilities are often concealed by designing bank officers in order to offset a shortage in the cash.

Coming to the assets side of the balance-sheet the first item refers to the cash position of the bank. This together with the second item "Cash at bankers" is designated as the "cash reserve" of the bank. This sum should enable the banker not only to meet the daily or ordinary demands of the customers but any extraordinary pressure at the same time. " Cash at bankers " represents the sum it has deposited with the Central bank in order to facilitate the clearing of cheques, which business will be explained in the succeeding chapter. The balances at correspondent bankers will also be included under this heading.

*Call loans* represent the ' overnight money ' or money lent for a period of seven days. The bank has the right to recall it within 24 hours or as in some instances within one or two hours. This money is lent at low rates of interest.

*Bills* discounted refer to the buying of the bills of exchange by the banker.

*Advances* are the loans made by the banker on the strength of security pledged by the customer or they may be granted on promissory notes or they may be the result of a customers' overdraft arrangement with the bank.

*Investments* refer to the bank's holding of readily realisable gilt-edged securities and other first class bonds. These act as a " balancing factor," making it possible to convert spare assets into investments, and liquefy investments to meet solid cash requirements.

*Bank Premises and Dead Stock* refer to the buildings, leases, office furniture and other effects the bank may possess. They are all written down to low figures far below their market value and every year a part of the profits is set apart to cover the depreciation of the furniture and other fittings of the bank.

Of these liabilities of the bank, the capital and reserve fund do not constitute a demand liability as they are payable to the shareholders alone who have no right to recall the amount of share money they have once paid in already. They can keep a vigilant eye on its proper use. Deposits on the other hand constitute a demand liability. Even in the matter of fixed deposits, competition among the bankers has settled the practice of paying them whenever demanded. It is only in a very rare emergency that the stipulated time notice is demanded by the banker. If the time notice is insisted upon, the depositor deduces the conclusion, that there is something rotten in the affairs of the bank and may induce other depositors to make a " run" on the bank. It is always in the best interests of the bank that a 'panic' should never be allowed to develop into a run for if all depositors claim their money at once no bank in the world would be in a position to pay them off in full at a moment's notice.

The acceptance business on behalf of customers constitutes a contingent liability, a liability dependent on the failure of its customers. The point to be noticed is that this item is a liability and an asset at the same time. The customers pay the amount in due course and so it is an asset. The concealing of assets is another well-known practice of bankers resorted to to avoid taxation. When liquid capital items are charged a higher rate than real estate and other property there is this temptation to conceal assets, and discourage competition.

Persons intending to deposit money in a bank should scan its balance-sheet carefully and notice the following points: the amount of reserve liability if any such thing is attached to the bank share, the proportion of the cash reserve to the outstanding demand liabilities and the quality of the gilt-edged investments it holds. If these things are satisfactory the bank can be trusted.

But after the War the bank balance-sheets are not so informing. Much information is withheld. Owing to enormous complications and cross-currents behind the figures it would be rash to draw hasty conclusions or inferences about their meaning.[1] All the bank balance-sheets have a large holding of Government securities as their assets and their holding of commercial paper is very small. Hence their resources are not so very liquid as in the case of the pre-War days.[2]

[1] For example the weekly balance-sheet of the Bank of England prior to Nov. 28, 1928, used to be an enigma.

[2] See Appendix I which contains facts and figures concerning the assets and liabilities of some of the present-day important banks of other countries.

# CHAPTER III

Bank deposits—origin—legal implication—banks and creation of credit—legitimate credit—bankers' classification of deposits—interchangeability between time and current deposits—economists' conception of deposits—increase of fixed deposits—democratisation of banking—importance of deposit function—the economic meaning of deposit—cheque currency—deposit habit—war-time inflation—prices and credit—credit inflation—its consequences—the real solution—cheap credit during war-time—banks and the productive processes of society.

## Section I.

### How the Commercial Bank obtains its Working Capital.

The working capital of a bank consists of (1) the paid-up capital belonging to the shareholders, (2) fixed cash deposits and current accounts belonging to the customers of the bank who have deposited them, (3) the sale-proceeds of drafts sold to persons who wish to remit money to a foreign country or a distant place in the same country. Cash is paid to the banker and he has the profitable use of this money for a number of days till the amount is paid to the customer.

## Bank Deposits.

Economists define bank deposits as the idle sum or "floating cash" or "current capital" handed over by the customers of the bank in return for which they receive a small rate of interest and other gratuitous services the banker may perform for them. The safe custody of valuables, the collection of interest coupons, bills of exchange and purchase and sale of securities through the banker's brokers, the issue of drafts and letters of credit and such other minor services are some of the useful operations of modern commercial banks. But the deposit business of a bank can be graphically described in the language of Lord Overstone who says, "It is my own brain and other people's money."[1] While trading with others' money he has to skilfully employ them in such a way as not to prevent them from being made available to the customer whenever they are demanded. As Taylor says, "Payment on demand is the fundamental right inscribed in the charter of the depositors' liabilities."[2]

Bank deposits arise in the following ways. Actual cash may be deposited or titles to cash owing to the customer are deposited for the purpose of collection. Deposits may arise out of loans granted by the banker. Deposits may also be created when the bank is making investments or purchasing assets by paying for them

[1] Even Recardo says the same thing. "A man becomes a banker only when he begins to lend other people's money."

[2] G. L. Taylor, "The Credit System," p. 108.

by a claim drawn against itself. The customer wants the right to draw so much money from the bank at the time of contracting the loan or he may prefer to get it transferred to his account as a credit item upon which he intends to draw later on. As J. M. Keynes says, "It is natural to think of bankers' loans as being the children of its deposits. But it is at least as true to think of the deposits as being the children of its loans."[1] Again deposits may be created by bills. The face value of the bill is credited to the customers' current account while the discount is debited. Thus the banker not only *attracts* deposits but actually *creates* them. The vast majority of deposits are not paid in but consist of credits borrowed from the banks. There is always a tacit understanding between the banks and their borrowers that actual money should in no instance be drawn out but that the borrower should use the accommodation by drawing cheques against it. This understanding is the *sine qua non* of all commercial banking business. As one economist puts it, "it is as much a dead certainty as any fact in economic life." David Friday declares this in the following words: "The unique power which the banking institution has is this ability to manufacture credit, sell the right of its use to individuals and yet be assured that the credit remains upon deposit with the bank and not be drawn out in such a manner as to subject the bank to depletion of its cash reserves."[2]

[1] J. M. Keynes, "Economic Journal," 1914. See also his "Treatise on Money," Vol. I, p. 24.

[2] David Friday, "Profits, Wages and Prices," pp. 213, 214.

## Legal Implication.

A deposit after all implies the right to draw legal money from the bank. This right may be created either by the customer or by the banker. In either case the banker must be willing to meet the obligation as soon as it is exercised by the customer. Thus the extent to which credit can be created by this means is limited by the amount of the cash reserve held by the bank.

Of the three classes of deposits, cash deposits are by far the most important ones to the banker. They form a desirable addition to the cash in hand. They enable the banker to lend more or create more rights to draw money than the actual sum represented by the cash deposit itself.[1] The banker knows full well that all depositors do not exercise their right at one and the same time. To quote W. S. Jevons, "the whole fabric of our vast commerce is found to depend upon the improbability that the merchants and other customers of the banks will ever want simultaneously and suddenly so much as $\frac{1}{20}$th out of the gold money which they have a right to receive on demand at any moment during banking hours." So with

[1] Some banks divide deposits into interest-bearing (fixed deposits) and non-interest-bearing as these belong to the 'current account' and are subject to cheque facilities. The growth of current account deposits indicates the loans and advances of the banker. The growth of fixed deposits indicates the prosperity of the people. During the period of the recent war both kinds of deposits have increased but current account deposits have increased more in proportion than 'fixed deposits.' The Indian commercial banks pay interest on both fixed and current account deposits up to a certain daily minimum.

this small amount of cash that is deposited the banker may create the rights to draw money to the extent of five or six times the amount. How far the extension of the liabilities can go is determined by the practical experience of the bankers. They know full well that continuous expansion of credit on a fixed cash basis will lead to a dangerous situation of "constantly increasing sensitiveness, instability, danger and ultimate catastrophic collapse."

The view is often held that banks cannot create credit and it is the contention of this school that banks grant credit out of what has been entrusted to them.[1] If banks undoubtedly maintain cheap rates of discount some entrepreneurs may be tempted to borrow credit. It also happens that if a high level of commodity prices is prevalent the credit needed is greater and banks usually create this credit in response to the legitimate needs of borrowers. The banks keep a certain proportion of cash, which practical experience enables them to determine, against the fiduciary money they create and as many banks create this fiduciary money against their gold cover the total volume of credit is a decent thing and although the banks refuse credit to some applicants it is entirely erroneous to hold the belief that banks can give credit only after receiving a corresponding deposit. Subject to the gold cover

[1] See Walter Leaf, "Banking." He holds the view "that the initiative comes from the depositors and the banks can lend no more than their depositors have previously entrusted to them." See F. W. Crick, "The Genesis of Bank Deposits," *Economica*, June, 1927.

they have to maintain, the credit structure always depends on the number of banks existing in the society and their willingness to lend to some applicants seeking credit.[1] Prof. Pigou expounds this conception in the following manner: "In all circumstances the credit structure is limited by the size of the base or volume of legal money and this is not under the control of the bankers. Although the total volume of credit created might be outside the scope of the individual banker's action still it is the bounden duty of the banker to create credit for legitimate productive purposes." [2] It is only when this legitimate demand for credit is denied by excessive limitation on the part of the bankers that there is a hue and cry on the part of the borrowing fraternity. Sound and legitimate credit can be secured if the bankers pursue the

[1] For a more recent statement see J. M. Keynes, "Treatise on Money," Vol. I, pp. 23-30.

[2] The characteristics of productive credit are defined by an Austrian economist in the following manner :—(1) The transference of money or real capital. (2) Postponement of repayment by the borrower because of the efficiency of his own economic power. (3) The enhanced utilisation of the borrowed capital by the borrowing economy as contrasted with the lending economy, thus implying an increased productivity of the relational economy and the creation of new capital. (4) The establishment of an economic community between the lending economy and the borrowing economy. (5) Precedence of the lending economy. (6) The representation of the future payment by a promise to pay which can enter into momentary circulation. This currency is based on the actually occurring economic expansion. (7) The creditor's trust in the debtors and the relevant legal relations (laws regulating credit and bills of exchange). These are not "presuppositions of credit" but actual formative factors in the economic process. See "The Types of Economic Theory" by Othmar Spann, p. 74.

golden rule of supplying credit in such a way that prices are not unduly altered. This ideal can be accomplished by scrutinising thoroughly every demand for credit and by carefully adjusting the interest rates with the above object in view. The aim of sound banking policy is to give tolerably comparative stability to the monetary unit.[1] An individual commercial bank whose sole object is to make profit and increase its business can never be expected to exercise this judgment. No one bank can do it by itself. It is a collective responsibility and collective action is necessary. Such detailed judgment can be exercised only by the Central Bank. It is the primary duty of the banks to look after the currency mechanism. So long as bank credit arises out of marketable goods the cheque currency created in the process of granting bank credit can be made to expand and contract automatically with the volume and requirements of trade. Too much reliance however should not be placed on the

[1] G. Cassel says, " The supply of credit must be so regulated that no rise in prices, and naturally no fall in prices either, takes place. In order to keep demand for credit within the limits of available means, the bank must apply interest rates fixed with that object in view but in their continued scrutinising of the demands for credit must also be able to make the necessary restrictions. The main factor determining interest rates throughout the entire banking system is the Central Bank's discount rate and in addition the Central Bank naturally possesses a very great influence owing to the general advice it is able to give the private banks as to their credit policy. A fixed value of the monetary unit can only be kept by properly limiting the granting of credit and principally therefore by suitable discount rate." " Money and Exchange after 1914," p. 103.

Also refer to his book " The Nature and Necessity of Interest," pp. 162 and 163.

efficacy of the discount rate in checking credit and controlling the volume of currency within such limits. If a large importation of gold takes place in liquidation of a favourable balance of trade it would generally bring about an expansion of credit in spite of moderately advancing discount rates of the Central Bank. It is at such times that in addition to the manipulation of bank rate the open market operations would have to be conducted to control effectively the credit situation.

## Classification.

Fixed deposits or "Time" deposits, as Americans style them, are attracted by the payment of interest which is usually higher for longer periods. A high deposit rate is not conducive to sound banking as it forces the banker to 'tout' for business and undertake risky ventures in order to earn a higher return for the money.[1]

Commercial customers usually have to maintain a minimum of balance in their current accounts and as this would not be drawn upon, the banker utilises it for creating the deposit rights, or as banking terminology styles them, in "credits." Bankers do not charge the

[1] Since these lines have been written Leonard Alston says that banks ought not to pay this "black-mailing fee" as he terms the rate of interest paid on fixed deposits. "Deposit interest" is a parody on interest payments proper or their survival is similar in its disorganising effects to the survival of reparation payments in the international sphere, both of them showing their worst features, partly as cause and partly as effect, during a period of monetary appreciation. Except by moralists who remain obsessed by the idea that abstinence *per se* is a moral quality deserving of economic reward much as war guilt is an immoral quality, deserving of economic penalisation, this will hardly be contested." *Econ. Journal*, June, 1932.

customers any commission because they make a profit out of its use which compensates them for the trouble involved in keeping the account. The practice with the Indian banker is to pay a low rate of interest even on current accounts provided they do not fall below a certain sum which is a device to minimise the risk arising out of the transaction ; for the customer, as long as he gets some interest, does not withdraw his money unless he finds a permanent and more profitable employment for it. People generally reserve their balances in the hands of the banks till they can consolidate them into a large amount and convert it into fixed capital or immovable form of wealth. Thus bank deposits represent capital withheld from permanent investment and is kept subject to immediate call. Banking theory condemns the paying of interest on operative current accounts but the smaller Indian joint-stock banks have always a small paid-up capital and in order to attract funds they prefer to pay interest on the current accounts of commercial customers even.

### Interchangeability.

Another remarkable fact which the practical banker experiences often is that the " time" deposits and the "current " account deposits become interchangeable now and then. When trade becomes slack the current account deposits become fixed deposits. On the revival of trade the time deposits might be converted to current account deposits. Excessive competition among banks might lead to higher interest rates and a shifting of the demand deposits to the category of time deposits would occur then.

## Economists' Conception.

Economists however are not pleased with this distinction between "fixed" and "current account" and 'savings' deposits.[1] They realise full well that "cash" deposits of the banks consist of the income deposits of individuals and business deposits of the business men.

Savings deposits are held till the time and opportunity arises for converting them into specific investments. The economist recognises that the distinction in the mind of the depositor between his *cash deposits* and *savings deposits* becomes very often blurred but he attempts to estimate accurately the proportions of the two in the total figure of bank deposits.[2] Unless such transfers and the frequency of such transfers

[1] For a good idea of the different types of deposits see the *American Economic Review*, Supplement, article on "Recent Changes in Banking," by J. W. Bell (March, 1932), p. 189, *et seq.*

[2] In the U. S. A. the proportion between the two is about one-half. In the pre-War United Kingdom it was roughly about one-half. See Keynes, "Treatise on Money," Vol. II, p. 8. Lacking statistics covering the entire ground nothing can be stated as regards the relative importance of the two types of deposit nor can the consequences of the transferences backwards and forwards between the deposit accounts and the current accounts and their influence on the price level be grasped accurately. A separate publication of the time and demand deposits should be insisted upon in this country. A calculation of the velocity of deposits would also help the practical bankers in the determination of the proper cash reserve they have to keep.

Mr. Keynes recommends the statutory enforcement of a separate cash reserve as against "time" and "current account" deposits. But as it is easy to evade the rules, the recently appointed Committee in the U.S.A. has wisely recommended the abolition of this distinction in the calculation of the required cash reserves. See the Report on Member Bank Reserves of the F. R. Banking System, *Economic Journal*, March, 1932.

is noted the problem of credit control becomes an impossible thing. The economist also draws interesting conclusions with reference to their shifting movements between demand deposits and long-term deposits. Not only does he deduce the conclusion that there is a rough parallelism between the movements of profits and creditors from short-term to long-term accounts but he also tries to find justification for the shift by noticing the changed tendencies of the economic operations. To be more explicit, the growth of long-term deposits depends on banking policy deliberately enforced on them by the industrial units securing long-term credits for rationalising their methods of activity or giving up discounting for direct bank advances to finance their normal operations. Thus an intelligent reading of the banking statistics would afford a clue for a clear understanding of the fundamental economic facts of everyday life.

## Democratisation of Banking.

An increase of higher interest rate on bank deposits or a mere performance of more services and granting of adequate facilities to the customers would achieve this purpose. A favourable banking policy conduces towards an increase in bank deposits. The habit of paying higher wages and salaries by means of cheques would compel the wage-earners to deposit them in the hands of banks. These gradually tend to acquire the banking habit and open bank accounts. One of the best methods of increasing bank deposits is to see that the capital of the bank is held by

well-to-do men who patronise the bank. Advertisement affords wider scope for increasing the bank deposits. That sound management is ensured can be advertised by publishing the personnel of the bank officers. A periodical publication of the balance-sheet figures will do much in this direction. The educating of the depositor as to the kinds of deposits and their advantages must also be done. Personal solicitation by the bank officers or others interested in it would go a long way in increasing bank deposits. A successful endeavour in the above directions would be crowned with success.[1]

## Importance of Deposit Function.

The deposit function of the banker is important because it has to aggregate small sums of money lying scattered here and there in twenties, fifties and hundreds. Singly these sums have no economic efficiency whatsoever. But they can accomplish Herculean tasks when they are aggregated and employed by the banker. According to Bagehot "the concentration of money in banks, though not the sole cause, is the principal cause which has made the money market

[1] If we consider English banking development the main causes that led to their growth were as follows :—(1) Opening banks or branches in places where private bankers did not exist; (2) by the commencement of acceptance business ; (3) the forming of foreign departments; (4) the opening of savings department for the deposit of very small sums; (5) the general development of manufactures ; (6) the conducting of scientific banking leading to freedom from failures.

See J. Sykes, "The Amalgamation Movement in English Banking," p. 114.

of England so rich and so much beyond that of other countries." This pooling operation of the banks and releasing the capital presumably to those who employ it in the most profitable way in the trade and industry of the country is the first economic service that banks render to society and their efficiency depends on the total wealth of the people they have amassed in their hands and the total demands of industry and trade on the other side would settle the loans that the banks can make.

## The Economic Meaning of Bank Deposit.

The bank deposit is a mere right to demand legal-tender money from the bank but the customer usually exercises this right by drawing a cheque on the bank and it is these cheques which constitute the major part of the medium of exchange in civilised communities. By this method the banks create purchasing power or "potential currency." This is the second important economic service which banks render to society.

## Deposit Currency.

Deposit currency or cheque currency or 'bankers' money' as it is properly styled is eminently elastic as these cheques can be multiplied by the banks to any amount within the limits of comparative safety and considerations of social interest as there are no legal regulations binding this side of banking business. The bank deposits that are created should help social production and aid the industrialists to secure

additional labour and raw materials necessary for increased output. This larger production may in the long run, by reducing overhead charges, lower the prices. If both prices and production are affected there is the greater advantage to society. But if bank deposits help speculation the prices of securities would be increased to the detriment of society. Again a too rapid credit expansion would certainly inflate the price-level. It is well nigh impossible to increase the physical volume of production to such heights as credit expansion might possibly have risen to. It is easy to expand credit to 3 or 4 times the normal limit but it is impossible to expand production to that size, hence it is inevitable for the price-level to be changed and the rise in the price-level is a foregone conclusion under these circumstances.

## The Meaning of 'Deposit Habit' or 'Banking Habit.'

By the 'deposit' or 'banking' habit is meant the practice on the part of the people to entrust their money to the hands of the banker who is guided by the opinion of economists who consider that "idleness of money is as bad as lack of capital." This money together with the paid-up capital and reserves that they possess is retailed by the banks into the hands of borrowers who put it to the most profitable use, thus maximising the return from it. This total stock of money which the banks hold is multiplied by them into the efficient stock of purchasing powers enabling people effectively to despatch their business and make

their payments with great ease and safety. The deposit habit of the people is the result of the "preliminary education of the bank note." As Conant says, "the bank note is the pioneer of credit and the apostle of deposit banking." [1] The holder of a bank note is induced to part with it to the banker for the sake of interest and for the sake of obtaining protection from theft or fire. Gradually this depositing habit once contracted becomes second nature and in modern times the cheque is reckoned as the symbol of banking progress. As Bagehot rightly observes, "no nation can arrive at a great system of deposit banking without going first through the preliminary stage of note-issue." The habit of drawing cheques has become deeply ingrained in the people of Great Britain [2] and the United States of America. It

[1] See C. A. Conant, "Principles of Money and Banking," Volume II, p. 270.

[2] This habit was fully tested three years ago when the stamp duty on the cheque was doubled. In spite of this increased impost the return of the Bankers' Clearing House show that there was a 70 per cent. increase in the number of cheques cleared. A recent writer says that 98 per cent. of all payments (taking value, not number) is now made by the cheque.

A device to overcome the heavy stamp duty is the newly arising habit known as the Credit Slip Clearing System which affords companies an easy system of paying monthly accounts and salaries with the additional merit of being less costly than sending cheques in settlement. Only the creditors must furnish the name of their bankers and the title of the account kept with them.

A series of credit slips are first obtained from the bank and the company proceeds to fill in the details. The names and addresses of the creditor's banks will be inserted together with the full name of the creditor and sum due to him, this being repeated in each

has now ousted the bank note and the bill of exchange to such a remarkable extent that Mr. (now Sir) D. Drummond Fraser, a practical banker, writes that "the cheque has hurled the note down from the pinnacle of power." Lord Avebury looked upon the cheque as a thing so distinctively British as to call it the " Union Jack of Commerce." The existence of commercial communities with highly organised business relations, a dense and rapidly increasing population, swift means of communication, the general education and intelligence of the people, and the growth of mutual trust and confidence which have been styled by Dr. Marshall as "social credit " are the necessary pre-requisites for the generation of the banking habit in any society. Any enforced stimulation on the part of the Government

case in separate slips. Having completed the list of disbursements the company is then required to number each slip and enter it upon a specification which is made out in duplicate the original being receipted and returned to the company by the banker while the duplicate is retained by the latter. The last formality to be completed by the company is the writing out of a cheque in favour of its banker for the total amount to be distributed. The cheque is debited to the company's account and the bank undertakes to deliver the credit slips to the various banks indicated therein. The extra work which is involved in this method is covered by charging reasonable commission. The saving in stamp duty is the main object of the new practice. See the *British Trade Review*, March, 1931, p. 23.

The Calcutta University can follow this system and save much clerical labour and accounting troubles for one thing. The saving in stamp duty will be another if its contemplated reimposition (Oct., 1932) on cheques takes place. Another advantage would be compelling the officers to open bank accounts

such as the guaranteeing of deposits to increase the deposit habit of the people is bound to fail.[1]

## War-time Inflation.

The war-time inflation and growth of banking deposits in all the belligerent countries arose out of the bank's subscription to war-loans, advances against war scrip by the banks and indiscriminate Government borrowing. A loan by a bank to the Government can be considered as an addition to the cash reserves and can be utilised as "a basis for potential increase of deposit currency to six times the amount."[2] This phenomenal increase of war-period deposits

[1] The pros and cons of this measure can be briefly stated as follows. The advantages of guaranteeing deposits are three in number, viz., the preventing of individual distress in case of bank failures, (2) withdrawals due to panics would be mitigated, (3) there would be a great reduction of the hoarding tendency. But the corresponding disadvantages must not be overlooked. The strong would be made to pay for the weak Loose and careless banking methods would be fostered. It would act as a premium on banking incompetency. Prevention of bank failures by the conducting of scientific banking is a better ideal than the concentration upon payment of depositors after the failure of a bank. Quite recently the U.S.A. banking system has once again inaugurated the guaranteeing of bank deposits. All banks have to join the insurance scheme by contributing a quota of their deposits. Strict supervision of these banks by the National Bank System and F. R. System will eliminate failures of banks, says President Roosevelt whose sole aim is to unify the banking system by increasing the membership of the F. R. Banking system.

[2] See a pamphlet entitled "Monetary Outlook" published by the Garton Foundation.

cannot be considered as representing the true course of normal development in any country.[1] Besides it could not have been maintained if the banks were not sure that the Treasury notes would be forthcoming when necessary. The increase of bank deposits together with the increase of Government currency notes brings about an enormous inflationary increase in the purchasing power of the people. The deficiency of normal production due to war-time dislocation on the part of the industrial system forces the price-level of commodities to a great height.

## Prices and Credit.

It is not germane to this subject to discuss the oft-debated question whether prices are the result or the cause of currency or credit expansion. Prof. J. S. Nicholson says that every increase of currency notes has been followed by a rise in prices. Dr. Edwin Cannan believes that the influence of money is of comparatively little importance when compared with the influence of rapidly expanding credit on prices. He argues that if banks had not granted loans, prices would not

1 The deposits of the Central Banks of all the active belligerent countries increased to 4·53 times the total deposits before the war and even those of the neutral and active belligerents increased to about 3·28 times. The deposits in the banks of the belligerant countries increased to 4·59 times : in the banks of the Allies the increase was 3·89 times and in the banks of the Central Powers it was 10 85 times the pre-war figure. See Dr. Freidman, " International Financial Reconstruction," p. 177.

have arisen and the increased volume of funds would have been unnecessary. Several causes [1] have operated in raising the price-level during the war period and it would be impolitic to consider one particular set of causes as mainly responsible for the increase of the price-level. As Prof. Foxwell says, " a rise of prices was inevitable whether new money was created or not." It is also natural enough to find that bank deposits increase during the period of inflation. Inflation of currency by increasing the competition of paper and credit with gold tends to lessen the value of gold itself but as Prof. Pigou points out " the value of purchasing power of money is not determined solely by the mere existence of an increased quantity of currency but by the spending or more exactly the expectation of the spending of the additional money."[2] When these factors are realised business men are naturally compelled to borrow more from the banks to enable them to command the same purchasing

[1] Profiteering, food-control, under-production, scarcity, and taxation are no less important than the inflation of currency. Together they have raised the level of prices to a great height.

[2] " In the early stages of a Government's use of the printing press in lieu of taxes, people may think that the rise in prices is temporary and so may hoard money against an expected fall. They lessen the velocity of circulation of their money resources. In these circumstances prices tend to rise less than in proportion to the expansion of currency. In later stages, they fear continued expansion and ' fly ' from the currency by buying jewellery, lessening their bank money, and balances and using foreign money instead of their own. They try to get rid of the native money the moment they receive it." Hence prices tend to rise more than in proportion to the expansion of the currency. See Essays in Applied Economics, p. 195.

power over commodities as before to conduct a given volume of business. Prices may rise sometimes on account of certain intractable non-monetary reasons and the expansion of bank loans may be a result of the *prior* increase of prices. Much has been written on this subject and the balance of opinion seems to incline to the conclusion that the price-level is the cause or at least the forerunner of credit expansion. A good deal more of proof and statistical evidence has to be adduced to enable one to conclude that in almost all cases prices are the result of the credit expansion of the bank.

## Credit Inflation.

So long as the depositors subscribe to the war loans out of their genuine savings there is mere shifting of purchasing power into the hands of the State but if banks help their customers to subscribe to the war loans there is inflation of credit. In addition to the contributory cause of bank inflation, the ordinary banks borrow from or rediscount at the Central Bank using war bonds as collateral security. Here again there is credit or bank inflation. The direct advances of the Central Bank to the Government to meet the deficiency of revenue on the creation of securities is another prolific source of credit increase on inflation. In normal times the Central Banks have to issue a limited volume of notes and with reference to the gold stock it holds. During the war time this limit is not adhered to. By this method " public

deposits " or Government deposits increase on one side while on the side of assets there is an increase of Government securities. When the Government dissolve this created credit, there is a shrinkage of " public deposits " and a swelling or increase of the " other deposits." This sort of book-keeping maintained by the Central Bank enables it to create credit during the war period without any check specially because gold payments are suspended. Gold is no longer the governor and regulator of the volume of credit. The decline in the ratio of gold reserve to liabilities matters little at that time. It is not national solvency but national success that is the burning topic during this period. All the wise principles for the creation of sound currency are scattered to the winds. The heavy intoxicating fume of " patriotism " created by national aggression and assertion obscures the necessity for the maintaining of the effective gold standard. The governmental inflation has well nigh broken the monetary and banking systems of the belligerent countries. The stock of gold in the hands of their Central Banks becomes so small that it would be disastrous to resume specie payments and restore the pre-war gold value of their currencies. The failure to balance the budget is the primary cause of Governmental or fiscal inflation. This leads to unstable prices, depreciated foreign exchanges, and progressive deterioration of domestic and internal business. The demoralisation of the financial system can be checked by controlling the prime cause, the unbalanced budget.

## The Real Solution of the Evil.

An effective solution to this would provide the key towards a stable currency or real economic rehabilitation and a better banking system. A mere raising of the bank rate or a "bonfire" of the existing currency notes will produce no effect so long as inflation proceeds apace increasing the purchasing power of the people. Sound currency can be restored by checking all influences tending towards Governmental inflation and by the withdrawal of the excessive and depreciated circulating media and limiting future issues to normal amounts. If these are not achieved commercial credit cannot be stabilised.

## Artificial Cheapening of Credit.

Another remarkable fact to be noticed is that this big creation of credit for war financing tended to cheapen bank credit. Low discount rates of 1½ to 2 per cent. were maintained. Lest the balances of foreign countries might be withdrawn from London a higher deposit rate had to be offered and even Treasury bills were floated at artificially higher rates and the Bank of England borrowed from the other banks for and on behalf of the Government. This cheapening of credit has been due to the Government methods of financing the war by loans from the banks and the consequent huge expansion of credit. But it must be borne in mind that other war-time measures such as the embargo or forbidding of exportation of capital and a

strict supervisory control of the new capital issues at home led to the artificial cheapening of capital.

After understanding the enforced necessity for war-time inflation, and the means for bringing about the credit inflation it must once again be emphatically stated that this creation of banking credit by book-keeping entries in the banks of the country does not increase its real prosperity. It tends towards the mere multiplication of bad money, depreciating its value and forcing up prices till the logical end, namely, the ultimate monetary collapse, is reached as in the case of Russia and Germany where currency units practically became worthless. As the Financial Facilities Committee points out, " some restriction is needed to check the undue expansion of credit and a mere expansion of banking credit would never by itself enable us to realise the millennium of riches and general happiness or a new economic paradise."[1]

## Banks and Production Processes.

Thus far attention has been drawn to the fact that banks manufacture cheque currency by their cheques against their current account deposits. It has been pointed out that an indiscriminate expansion of bank currency is fraught with disastrous consequences. But the banks are closely related to the productive processes of society. By judicious granting of banking accommodation the new supplies of capital goods and

[1] See the Report of the Financial Facilities Committee, the United Kingdom, November, 1928.

liquid capital which the entrepreneurs require can be easily acquired. The banks are also related to the exchange process. The commercial banks generally help the financial institutions, *i.e.*, the underwriters and investment banks of the country, to raise fixed capital and thus aid the smooth functioning of the business organisation in general. The behaviour of the banking system in the matter of business activity and industrial fluctuation will be studied in the section on loans and advances.

## Section II.

### Note Issue.

In addition to the privilege of lending credit in the form of deposit liabilities, some commercial banks are endowed with the privilege of issuing bank notes.[1] "A bank note," according to economists, "is an impersonal bill of exchange drawn for a standardised amount and enjoying wider negotiability than the bill."

H. D. MacLeod says, "bank notes were in use in the second century B. C." They were made out

[1] In the United States of America the National Banks have the privilege of note-issue. In Canada and Scotland every bank has the privilege of issuing notes. In India there is not a single bank of issue. In England it is the Bank of England alone that has the monopoly of note-issue. All the pre-1844 banks issuing notes have either lost their privilege of note-issue or are not anxious to issue notes.

of pieces of skin upon which the value was stamped by an official seal. Certificates representing gold and silver deposits were circulating in China as early as 807 A. D. Paper money [1] was designated 'flying' or 'current' money and was very extensively used in China in the tenth century. Early in the beginning of the eleventh century a joint-stock company was specially authorised to issue notes redeemable after three years but the company did not fare well. This seems to be the earliest instance of partially covered note-issue. The use of bank notes in Europe has been attributed by several writers to a certain Palmstruch who founded the Bank of Sweden in 1658. In England, however, the goldsmiths' 'receipts' paved the way for the bank notes. In India the banks had the power of note-issue till 1861 when it was annexed by the Government of India at the instance of James Wilson, the originator of the Government paper currency scheme.

The function of note-issuing is to accumulate the small capital of individuals and split up the aggregate again into small and even amounts that suit the business needs of the community and transfer these into those hands who can most effectively employ them. The bank guarantees the note by its own endorsement and so long as the credit and business reputation of the bank is unimpeachable the notes are considered

1 See Norman Angell, "The History of Money," p. 81.

2 For an early history of the bank note-issue see my book "Organised Banking in the Days of John Company," Ch. III, pp. 104-152.

as " good as gold " itself.[1] So a note-issuing bank should like Ceasar's wife be above all suspicion.

The primary object of a bank issuing a note is to coin such credit, as is easily acceptable by the people and as has command over commodities like metallic money. This object is best attainable if the bank note of a particular form and material is issued in convenient denominations provided that it is promptly redeemable in legal tender money and is easily transferable from hand to hand with the least formality.

The occasion for the issuing of the bank notes arises in the process of discounting bills or when the bank grants loans to the traders. Whether the bank credit is to take the shape of a deposit or note does not lie in the hands of the banker but is purely a choice of the customers of the bank. Only one broad fact need be stated; the customers of a city bank would prefer bank notes.

There is absolutely no difference to the banker if his credit creation takes the shape of a bank note or deposit. If at all there is any difference it is one of form, perhaps the bank deposit is more useful to the businessman than the bank note. But there is an identity between the bank note and the bank deposit. Both of them can be used for the purpose of making advances to customers or in exchange of promissory

[1] As Lord Mansfield said (in Miller *vs.* Race, 1758-1, Burr. 452) " Bank notes are not goods, nor securities, not documents for debts nor are they so esteemed but are treated as money, as cash in the ordinary course and transaction of business by the general consent of mankind which gives them the credit and currency of money to all intents and purposes."--Quoted from Thompson's Dictionary of Banking.

notes or bills of exchange of customers. Both of them serve as promissory notes or bills of exchange of customers. Both of them serve as a means of payment. Both of them represent the right to demand legal tender money from the bank. Both are sources of income to the bank. Both are demand liabilities from the viewpoint of the banker. But the bank note is a safer liability than the deposit, and the bank considers it advisable to issue credit in the shape of notes in preference to deposits. So long as there exists confidence in the issuing bank no depression of industry destroys the use of the bank note. A deposit may be utilised at any time by the customer to meet his own obligation. The smaller bank notes remain out in circulation for a long time[1] and very often return as deposits.[2] The bank note has a greater circulation power than the cheque. If the moon is the poor man's lantern the bank note represents the poor man's banking account. So there is not much trouble in the issuing of notes in response to the legitimate demand on the part of the people. All that the banker has to remember is to arrange for the prompt and immediate convertibility of the notes into lawful legal tender money.

[1] Turner says that the Bank of England received 1,400 bank-notes of £1 each which were hoarded for about 24 years till 1843. In the same year one £20 note which was hoarded for 125 years was presented for encashment and all these were paid in full. (Chronicles of the Bank of England, p. 150.)

[2] Torn and dirty notes cannot again be issued for hygienic reasons.

It is indeed a pity and blunder on the part of most of the Governments that notes have been discriminated from all other forms of credit and subjected to rigid legislative control.[1] It might be true that in the early days of banking development the note-issue was more important than deposit business, when shackles were forged for it. English banking history records that the deposit function grew into prominence owing to the too narrowly restricted note-issue system. But all countries have deemed it wise to improve legal restrictions in the matter of their note-issues. The notes fall into the hands of the poor and ill-informed people who become the involuntary creditors of the bank. As Leon Say points out " the bank note is the deposit account of the humble citizens and small merchants." A failure of the note-issuing bank

[1] Some notable exceptions are the F. R. System of America and the New Reichsbank Act of Germany. In the former case the F. R. Banks have to maintain 35% cash reserve against their demand deposit liabilities. In the case of the latter the definite liquid assets of gold or gold securities of 40% have to be maintained against demand deposit liabilities of the Reichsbank. It has to hold 40% of its deposit liabilities. Some of the newly arisen Central Banks make no essential difference between notes and deposit liabilities. Cash reserve must be held against both types of liabilities. See the Memorandum on Central Banks issued by the League of Nations. See also Kisch and Elkin, Central Banks, p. 80. " Albania, Australia, Danzig, Denmark, Egypt, Germany, Japan, Latvia, Lithuania, Norway, Russia, Spain, Sweden and Switzerland hold reserves against notes only. Whereas Austria, Belgium, Bulgaria, Chile, Columbia, Czechoslovakia, Ecuador, Estonia, Finland, France, Greece, Hungary, Italy, Java, Netherlands, Peru, Poland, and South Africa have reserves against *Notes* as well as sight liabilities or deposits."

See Sir R. N. V. Hopkins, Memorandum on note-issue submitted to the Macmillan Committee.

spreads misery amongst these poorer classes. Bank notes form part of the country's currency and just as metallic currency is controlled by the State the note-issue should be controlled for the very same reasons. The depositor is not protected by any laws because he is rich and can sustain the loss and because he deliberately makes a choice of his own bank and none but himself reaps the reward of his intelligent choice. The depositor has the right to close his account at short notice. Deposit creation is virtually and automatically kept under proper restraint as the issued cheques tend to be presented to the Clearing House by the other bankers with the result that a deficit in cash ensues and delimits any of these issues. Besides uniform rules can be made applicable in the case of bank notes only. It is a matter of small surprise that all countries have thought it fit to legislate on this topic.

The protection which the law affords to the note-holders varies in different countries. American banking legislation is very prolific in this matter. Firstly, we find the note-holder declared as a preferred creditor of the bank [1] having the first lien on the assets of the bank. Secondly, every shareholder of the bank is made liable to twice the amount of his share and this special liability creates confidence as regards the availability of funds for bank-note redemption. Thirdly,

1 In the Canadian banking system the note-holder has the first lien on the bank and has a prior claim even against the Government deposits which may be lodged in the Chartered Bank. Even in the National Banking System of the United States in America this way of protecting the note-holder exists.

the note-issuing banks have to contribute a 5% proportion of their actual circulation to the pool entitled the Bank Note Circulation Redemption Fund. Payment is made out of this pool to the note-holders of the failed bank. Again the issue of the notes might be kept under rigid supervision of a controlling body known as the banker's association. Insistence on daily redemption or encashment of each other's notes delimits overissue. Another method of protection afforded is the selection of safe and liquid investments alone which the banker can use as cover for the notes. The quality of the commercial paper against which notes can be issued can be defined. Beyond a fiduciary limit which is usually composed of Government securities every additional note might be made issuable against a corresponding gold reserve. The system of Government guarantee might also be extended to the note-issue of the Central Bank as in the case of the F. R. Note-issue. Lastly the note-issuing department might be separated from the banking side of the Central Bank as in the case of the Bank of England and the Australian Commonwealth Bank. Note-issue is freed from the hands of those who manage the banking department and who are the persons most likely to be tempted to overissue them. However enlightened and various might be the devices hit upon the sole objective in each case is to keep the volume of notes which is just needed by the business requirements of the people and secure the solvency of the issuing bank in each and every instance. Everywhere a great amount of solicitude is displayed on the part of the

legislators to secure the best interest of the note-holders.

In consequence of such elaborate legislative requirements safeguarding the note-issue of the banks, in consequence of the prompt and efficient redemption of these notes and in consequence of the fact that the issuing bank's name is widely known the bank notes have wider acceptability than any other form of bank credit and are eminently suited to function as a popular medium of exchange. Sometimes they are endowed with the quality of legal tender and this further heightens the popularity of the bank-note.[1] A legal tender bank note is kept in the tills of the ordinary banks as part of their cash reserve.

It is not without due and mature deliberation that it has been decided to control effectively the note-issue privilege of the banks. No other topic in banking theory has been the subject of such acute controversy which raged in the early beginning of the nineteenth century.[2]

The contending schools of thought gave birth to the two well-known principles of regulating the note-issue. The one is known as the Currency Principle and the

1 It is the notes of the Central Bank alone that can have this coveted privilege conferred on them. The F. R. Notes however do not enjoy it. This was meant as a desirable check against the too easy elasticity that might be attendant on the note-issue.

2 The depreciation of the notes of the Bank of England during the period of suspension of cash payments till 1821 led to a thorough discussion on this topic. H. O. Meredith says, the " Banking and Currency schools of thought were the intellectual heirs of the Bank Directors and the Bullion Committee of 1810."

other is styled the Banking Principle. The currency principle [1] considers the unrestricted issue of notes as dangerous to the body economic of a nation. It presupposes that there is a natural tendency on the part of the banks to overissue paper which tends to drive out precious metals from the country and that every deficiency of precious metals is filled up by the new issue of bank notes. Hence the advocates of the Currency Principle strongly urge the depriving of banks of their power to issue notes. If at all they are to be issued " they should not be issued beyond that amount at which they could fluctuate exactly as a metallic currency would fluctuate." This limit is to be found in the issue of notes as " certificates fully covered by coin or only in such amounts without a metallic cover as would constitute the maximum amount below which the circulation is never likely to descend." It is the opinion of the advocates of the currency principle that " banks should not be allowed to increase their paper circulation when specie is exported from the country but should reduce it in due proportion to the specie exported abroad." A clear-cut statement of the currency principle or a theory of the " self-correcting purely metallic currency " can be had by perusing the evidence of Lord Overstone before the Parliamentary

[1] Lord Overstone, Norman and Peel are the exponents of the Currency school. See Lord Overstone, " Thoughts on the Separation of Departments of the Bank of England." G. W. Norman, Evidence before the Select Committee on Banks of Issue in 1840; Qn. 2018.

Committee preceding the English Bank Charter Act of 1844.[1]

The advocates of the banking principle, *viz.*,[2] Tooke, Fullerton and Wilson on the other hand, refute vigorously the principle of "purely metallic currency." They say that so long as sound banking is carried on the notes can never be overissued, if they are made convertible into standard money. They consider that a depreciation of notes is impossible as long as they are issued against sound commercial paper. So they deprecate the curtailment of the freedom of the banks to issue notes. All that the banks have to do is to discount paper based on trade transactions and created by men of sterling integrity in business and follow a prudent policy in lending credits. All other precautions are unnecessary and hinder the smooth progress of the community. Prof. Bonamy Price, who makes a summary of the tenets of the banking school emphatically

1 "A metallic currency, I conceive, by virtue of its own intrinsic value will regulate itself, but a paper currency having no intrinsic value requires to be subjected to some artificial regulation respecting its amount. The issue of paper money is resorted to on account of its greater economy and convenience, but it is important that paper currency should be made to confirm to what a metallic currency would be and especially that it should be kept at all times of the same amount. Now the influx and efflux of bullion is the only sure test of what would have been the variations of a metallic currency and therefore I conceive that that constitutes the only proper rule by which to regulate the fluctuations of a paper currency." The groundwork of this statement is to be found in Ricardo's High Price of Bullion which was published in 1810.

2 See Tooke, "Inquiry into the Currency Principles," John Fullerton on "the Regulation of Currencies,"—Wilson, Capital, Currency and Banking.

says, that so many bank notes circulate as the public has a distinct want and no more. It follows the universal law of all commodities in use, *viz.*, the law of demand and supply. Neither bankers nor the needs of the borrowers, nor Parliament, nor suspension of the Bank Act, but the wants of the public, its willingness to hold bank notes, the number and amount of the specific payments which bank notes accomplish with a certain spare stock as for all articles in use, can determine how many convertible bank notes remain in circulation." [1] According to the advocates of the Banking School the volume of bank notes should never be restricted. Mere convertibility into standard coin is a sufficient deterrent to the over-issue of notes.

Banking history has afforded conclusive evidence that neither the theory of a self-regulating convertible note issue as postulated by the Banking School nor that of an automatic purely metallic currency as adumbrated by the Currency School is wholly correct. The Currency School commits the fatal error of thinking that it is wrong on the part of the bank to fill a void in the monetary circulation of the country by issuing notes. That bank notes alone constitute a special danger is another significant error. Deposits act alike and tend to drive out specie and encourage speculation, so there is no reason why they should be left untrammelled. The sole merit in the Currency School lies in the fact of its recognition

[1] Prof. Bonamy Price, "Currency and Banking," p. 54.

that "mere convertibility of the notes into coin will not act in a sufficiently prompt and drastic manner to keep the level of prices to what it would have been with a purely metallic currency." The Banking School errs in not recognising this fact. Besides in the very fact of the convertibility of the notes lies the danger of the specie being drained away. Good and sound banking and active and alert management on the part of the bank directorate is not to be had everywhere and at all times. An unscrupulous banker may lower his discount rate and unduly extend his business with the help of his notes. The bank while issuing bank notes is but "an instrument in the hands of the public" and it is possible that a grossly unfair use of it may be made.

But the Banking School has done unique service in pointing out that a country foregoes one of the best advantages of paper currency if banks are prohibited to fill up a void in the volume of currency whenever it occurs. The principles of sound currency suggest that such a gap should be duly filled up by self-liquidating paper instruments. The community should be saved from all inconveniences of sudden contraction of metallic currency and the stability of commerce and business activity should be provided for by a uniformly steady currency. Adherence to the Banking School may also avert the monetary crisis which may arise out of the operations of foreign exchange. If the bank note were to be purely a warehouse certificate nothing further than the saving from wear and tear of the precious metals would be realised.

Economists are sharply divided as to their opinion on these two principles. Prof. W. S. Jevons is an adherent of the currency principle. Dr. N. G. Pierson considers that the currency principle is less dangerous than the banking principle and agrees with Walter Bagehot in preferring the 'mediocre rules imposed on the Bank of England by the Act of 1844 to those which the Bank Directors might have invented for themselves.[1] It must however be candidly admitted that neither principle recognises the complicated nature of relationship between money and prices and no banking policy can succeed which does not take into account this complicated nature of the monetary phenomenon.

As a matter of fact all countries consider it wise to regulate their note issue and as many as fourteen different methods of regulation have been enumerated by W. S. Jevons. All of them are reducible to the five following principal methods of regulation adopted by the leading countries.

The first method is the limitation of the maximum amount of note issue at a high figure. The aim here is that by restricting the quantity there is less danger from an independent management and that notes cannot be over-issued in such large numbers as to threaten a complete bankruptcy. The issue of notes by the Bank of France prior to the year 1928 and the English country banks illustrates this method.

In the case of the pre-war period of the Bank

[1] See Dr. N. G. Pierson, "Principles of Economics," Vol. I, p. 461.

of France the maximum issue was always raised so that business interests might not suffer from the inelasticity of the note issue. There were no other restrictions binding the note issue of the bank. Quite recently, the Bank of France gave up this method of note issue and adopted the minimum proportional system of note-issue.[1] Metallic cover has to be kept against note and demand deposits to the extent of thirty-three and one-third per cent.

The second method is to follow the "partial deposit system" as in the case of the Bank of England. A certain portion is declared as "fixed fiduciary issue" and every note above that limit (£260 millions) is to be based on gold bullion or coin deposit. The greater the issue of notes the higher would be the backing of gold to notes and the notes would become more secure. But this system of regulation renders the note-issue inelastic and notes cannot be forthcoming at the time of crisis. To overcome this rigidity the C. Bank is often empowered to overissue notes beyond the fiduciary limit for a period of six months and a further period which may extend up to two years at any one stretch of time. The Treasury would however have to be informed of this emergency over-issue.[2] The note-issues of Norway, Japan and

[1] See the Monetary Reform of 1928 and the Bank of France.

[2] The Act of 1928 has conferred the much-needed elasticity on the note-issue somewhat exactly on the lines mentioned in the test. See "The Pound Sterling" by Feaveyear, p. 330; see also the Macmillan Committee Report, Ch. IV, pp. 28-30. At the present moment (January, 1931) the fiduciary issue is increased by about 15 mils.

the Swedish system are based on the fixed fiduciary issue plan.

The third method is to stipulate for minimum percentage or fixed proportional reserve against the notes issued. The defect of this system is that gold reserve is rendered useless and it unavailable at the time when it ought to be most available to the banker. If there is a withdrawal of gold due to exportation the quantity of note-issue should be reduced according to the ratio selected. Were an importation of gold to take place, an undue expansion of bank credit would ensue unless the C. Bank promptly and wisely sterilises the incoming gold. Sir R. V. N. Hopkins says,[1] "The oscillations under the proportional reserve system in the absence of a sufficient reserve would necessarily be more violent than under the system of a fixed fiduciary issue." This system requires the bottling up of an "extravagantly large stock of gold" as the needed cover for the note-issue and so long as the "free gold" is fairly heavy the currency system would not become subjected to great disorders.[2] This method of regulating the

[1] In his Memorandum on the Note-issue of the Bank of England, pp. 322-30, Vol. II, Evidence before the Macmillan Committee.

[2] J. M. Keynes says, "The percentage system has no sound foundation in logic or commonsense. I have never seen in print a reasoned defence of its provisions. It appears to combine all the possible defects of the system of note regulation." See "Treatise on Money," Vol. II, p. 268. But Prof. Keynes is unduly harsh on the demerits of the system. He does not take the merits of the system into account. This system can be made to work to the entire satisfaction of the country by some amount of prudence on the part of the bank authorities.

note-issue was adopted by the Bank of Belgium and the Bank of Spain. Denmark follows this system. The newly established F. R. System of the United States has fixed 40% as the minimum gold reserve required, but this limit can be suspended on the payment of a graduated tax on the deficiency of cash reserve. Almost all the recently organised C. R. Banks are adopting this self-same method of regulating their note-issue. But some of these C. R. Banks do not hold the percentage reserve against the note-issue in actual gold but in bills or cash at some foreign bank. Some proportion of the reserve might be held in interest-bearing foreign bills of exchange as an alternative to gold.

The fourth method is the much appreciated pre-war German system of elastic note-issues. The pre-war German note-issue was practically the same as that of the English note-issue with the super-imposed regulation permitting the emergency note-issue on the payment of the five per cent. tax. The Reischbank recently adopted the percentage system of note-issue. In fact, whatever be the method of regulating the note-issue, definite provisions for securing elasticity are being enacted so that elastic credit control can be realised in actual practice.

Lastly, there is the method of free issue of notes. The banker alone has the choice to expand or increase the notes according to his own discretion. This system has been most adversely commented on and it is declared that disastrous results would follow " free issues " similar to what would be in the case of

" free love " or " free trade " in intoxicants and no country has thought it wise to experiment with it on a large scale.[1]

The early nineteenth century opinion was that the essence of banking lay in the privilege of note-issue and that no institution could conduct flourishing banking business without that privilege. The development of latter-day joint-stock banks into gigantic institutions wielding a great amount of deposits has controverted the above opinion. The growth of big banking concerns as a result of the concentration tendency so clearly manifested in the field of transportation, mining, and manufacturing industries has ended in producing such huge banks that overshadow even the Central Banks, although the latter are armed with the monopolistic privilege of note-issue. The notes have been thrown into the background by the cheque [2] which by their own intrinsic

[1] About 16 of the States of the United States of America adopted this free banking system in whole or in part. Hundreds of banks came into existence without paid-in capital of any amount. They issued notes freely, paid out nothing but paper, and where inspection was provided by the laws, managed by thoughtful methods, to evade bank examiners. They were banks of issue only. If banks in larger towns or cities attempted to do a legitimate banking business they soon found that their own notes were promptly returned for payment while those of worthless institutions continued to circulate. In many cases, it was difficult, if not impossible, to find " the issuing bank." Many of these institutions were located in the depths of forests where there were few human inhabitants but plenty of wild cats. Thus they came to be known as the " wild cat banks."—H. White, " Money and Banking," p. 327.

[2] It is calculated that in peace times about 75% of the Bank of England notes finds its way into the tills of the banks. Bank notes

superiority are fast superseding them.[1] The cheques can be drawn to a fraction. No receipt need be kept of the payment made by the cheques. The worry of keeping additional coin is rendered unnecessary. Cheques can be duplicated if lost. The banker's book affords sufficient proof of payment. No wonder then the cheques have become the preponderating medium of exchange. The development of the clearing principle added great impetus to the nimble cheque and it has out-distanced for ever the bank notes. Although the currency principle governs the note-issue still it is the banking principle that is adhered to in practice. Elasticity of currency is procured by cheque currency and the modern bank note tends to merely supplement the metallic currency of a country. Even in the continental countries where the cheques are not so popular the bank-note is very important. The system of " giro-transfer " adopted by the Central Bank has affected the popularity of the bank notes. In addition to this "giro-transfer" system they have pitched upon the "postal cheque" system which affords those countries the easiest and cheapest form of internal remittance.

Modern banking theory does not uphold the

are used in solicitor's settlements which have to be made in full legal tender form and by holiday-makers in places where they are not known but the average amount of these was only £8 ms. Notes issued by the Scottish and Irish Banks are used for more general purposes but they amounted to only £15 ms., while the total of those issued by the provincial banks in England was only a few hundred thousand pounds.

[1] See Tooke's " Inquiry into the Currency Principle," Ch. V (Deposits and Cheques).

mixing up of note-issuing with commercial banking. The commercial banker is solely guided by the motive of profit and the shareholders look upon the bank as a mere dividend-paying machine. Hence a commercial bank is not in a fit position to contract bank note currency whenever it is so required. Its interest lies in the direction of expansion. Besides a decentralised note-issue as the result of several commercial banks being endowed with note-issuing power has its own danger which becomes manifest in small scattered reserves of gold which cannot be easily pooled in he hour of emergency. There is no unanimity, no uniformity nor any sole actuating impulse in the matter of currency creation. A decentralised note-issuing system renders it extremely difficult for any one bank to exercise effective control. This was recognised years back and the note-issuing function is now unified in the hands of the Central Banks. Though some of the existing provincial banks in England have the power of issuing notes still left in their hands they do not care to make full use of it. They have adapted themselves to new operations. The practice of concentrating banking power in the hands of big banking amalgamations has also rendered the note-issue unimportant to these banks. Everywhere there is only one kind of bank note—the Central Bank note and the Treasury notes and the private bank notes are becoming fast eliminated from the monetary field.[1]

[1] No reform is considered so essential in the U. S. A. monetary field than the matter of making the F. R. Note the sole medium of exchange. Diversity in the matter of monetary circulation leads to no important advantage.

Everywhere it is being realised that the older methods of reguating the C. Banks' note-issue and the cash reserve kept against the same have become effete. No system of note-regulation is giving entire satisfaction. Every one desires a radical reform in the existing Central Banking practices with reference to their gold reserves. There is a consensus of opinion that if the note-regulations were to fix a sufficiently high maximum amount of note-issue and minimum gold reserve which can be altered from time to time to suit [1] the exigencies of circumstances, the efficiency and economy of bank-note currency can be secured by conscious and intelligent management on the part of the Central Bank.

## Section 3.

### Bank Drafts.

The etymological meaning of the word "draft" includes cheques, bills of exchange and bank instruments drawn by one bank on another bank or by the branch bank on its head office or by a foreign bank on a bank in another country. In this section however "drafts" are used in the sense of bank drafts only.

[1] The Bank of Spain regulates the note-issues and reserves in this manner. The Spanish system combines a fixed maximum issue with a minimum percentage for the gold reserve varying with the size of the issue. See C. H. Kisch, "Central Banks," p. 81

Customers who wish to remit money may have recourse to a bank and obtain a draft. The amount of the draft is debited to the customer's account or a cheque taken from the customer for the amount. Besides customers, the outside public have realised that this method of remitting money is a cheap and expeditious one and when an outsider applies for a bank draft he has to pay cash for it on the spot to be delivered to the place he indicates. A draft issued by a branch on the head office or by one bank on its Agent bank in another place cannot be dishonoured. There is no question of acceptance of a draft. Money has to be paid to the legitimate holder of the draft. Due notice should be issued to the Agent giving details of the draft. Commercial banks maintain reserves in the hands of Agents or correspondents so that they can be used as the basis for the sale of exchange drafts which can be sold on this balance. Customers might be given letters of credit. Payment for all these purposes can be forthcoming from the balance maintained by the bank. Overdraft arrangements can be made so that these functions might not become impeded on account of the lack of foreign balance. So long as such arrangements are cheap and reliable and might not be cut off at any awkward moment it is not incumbent on the banker to maintain the foreign balance always in credit. Minimum balances are generally kept for a satisfactory discharge of these duties in spite of the fact that they earn very low rates of interest. To an exchange banker however the state of these foreign currency balances is very

important. An Indian exchange banker would have to maintain "Nostro" accounts with the foreign banks or [1] offices. All collections on behalf of the Indian exchange banker will be credited to these accounts and all payments on his behalf are promptly debited to this account. Any other agency work required by the bank would necessarily be done for a slight commission and the maintenance of an active account with the foreign bank or agent or correspondent depends on the necessity for this business. If the bank undertakes a large amount of remittance and exchange business, the state of the foreign balances should be substantial.[2]

[1] If the foreign exchange banks maintain Rupee balances and accounts these are known as " Loro " accounts.

[2] See my Present-day Banking in India, chapter on " Exchange Banks."

# CHAPTER IV

## What the Commercial Bank does with its Working Capital.

It has been shown in the previous chapter that the commercial banker does not depend solely on his own capital. He makes the community lend him capital either knowingly as in the case of deposits or unconsciously as in the case of bank notes and bank drafts. As MacLeod says, "Banking consists in buying debts with promises to pay." [1] Bankers obtain command of the floating capital of the community for which no permanent investment has yet been discovered and promise to pay it back on demand. The banks have the power of procuring money and it tantamounts to the actual possession of money itself for "money *in posse* is equivalent for all purposes to money *in esse*."

This is the nature of the banking contract and in order to execute this contract fully and satisfactorily the banker should be in a position to discharge his liabilities by means of his assets. He has to distribute this floating capital in such a way as to obtain him enough remuneration over and above what he pays for it and in such a way as would be immediately available

[1] H. D. MacLeod, "Theory and Practice of Banking," 3rd Edn., Vol. I, p. 278.

to him. He should in no case destroy the essentially liquid character of the circulating capital entrusted to him by converting it into fixed or permanent investments. As Prof. P. Leroy Beaulieu says " banks are intended to circulate capital and not lock it up." The banker can do with his own capital as he thinks it best for him to do but he cannot afford to play ducks and drakes with others' money. The banker can issue his own credit as the equivalent of the metallic money but even in this case he should issue it in due response to the requirements of business and always observe a safe and proper ratio of it to the cash reserve he maintains.[1] Banking credit becomes converted into metallic money as it is easily acceptable by the community which believes in the conspicuousness of the bank's position and has thorough faith in its solvency. The sole business of the banks is to create this credit cash or banker's money. Though this may not be considered as actually creating capital yet credit can be easily converted into cash at any particular moment.

It is not the banks alone that are endowed with the privilege of creating money. The Government itself can create such kind of money. Both bank money and Government money exert the same kind and

[1] The critics of the modern banking system who realise that banks are unduly restricting credit for legitimate productive uses even wish to improve the better ideal of creating credit with reference to legitimate credit demand on the part of entrepreneurs. Credit ought to expand in due proportion to the expansion of business on the part of society even though the gold basis of society is stationary or is not expanding. See L. D. Edie, "Banks and Prosperity."

amount of influence on prices. While the banks' power to create money is limited to the extent of its capacity to redeem its own promises, the Government's power to issue money, specially if it has no intention of redeeming them in the near future, is unlimited. It finds its Fortunatus Purse in its printing press. As the bank issues its notes on promises to the borrower it has to consider its ability to repay the loan to the dipositor. It is this that really checks the indefinite expansion of banker's money. As this check does not operate in the case of the Government's issuing of money there might be the possibility of an indefinite issue of Government paper money only limited by the grave social troubles engendered by the regime of rising prices.[1] Exchanges at home and abroad become disorganised. A premium on metallic money would ensue. A high rate of interest and a low rate of real wages are the accompanying indices of this period of inflation. Traders would be unable to liquidate their obligations as before under the simple gold standard system when every paper promise to pay gold could be converted into actual gold. Such things would go so far as the community would tolerate and no further.

[1] Mr. F. A. Vanderlip says, "If I were an incarnate devil whose sole objective was to bring upon human beings a reign of injustice and misery and could use only one instrument for the purpose, I should choose a Government printing press. With it I could bring about a chain of evil events which would paralyse industry, make a mockery of thrift, and effectively undermine morality. It is difficult for any one who has not experienced the evil results that inevitably follow prolonged inflation to comprehend what a diabolical instrument is the currency printing press." "What Next in Europe," p. 47.

An attempt will be made in the following sections of this chapter, to explain how the banker selects his assets and varies them and what considerations guide his intelligent judgment and choice. The banker always likes to choose such interest-yielding liquid assets that are readily convertible into legal tender money even in time of panic; which will pay depositors and at the same time permit new loans.[1] The attainment of maximum economic progress is the endeavour of the banking system as a whole and each individual banker is actuated with these self-same ideals. Within the limits of these ideals the banker ranges his choice amongst the four broad categories of his assets, *viz.*, call money, bill discounting, investments and advances to customers. During days of economic instability every bank endeavours to increase the liquidity of its assets. When trade is booming and more requests pour in for bank advances some of the banks' liquid investments are realised and loans granted out of these proceeds. If trade is slack and industry is languishing thus leading to reduced requests for loans from the hands of the banker the investments of the banker increase. Thus there is a constant measuring of the economic forces by the intelligent banker before he takes any particular line of action in making or changing the form of his assets. His sole endeavour is to maximise the economic optimum. This constant weighing and balancing of the economic

[1] J. G. Cannon quoted by F. A. Cleveland: "The Bank and Treasury," p. 66.

facts solely explains why the different asset items of the banker do not remain stable at one comparatively stable figure. They are as changing as the dynamic conditions of society permit them to be.

## Profitable Assets.

The assets of a bank are of two kinds: (1) those which earn the banker some profit and (2) those which do not earn for him anything but still must be kept by the banker in order to conduct his operations. Call money, discounts, advances, investments and acceptances fall into the first category. A certain amount of cash or legal tender cash reserve is absolutely essential to inspire confidence among the customers of the bank as without it it cannot carry on its business. Dead stock includes buildings, fixtures, and other effects which are necessary for the bankers' business but which do not fetch a return. It is indeed a truism to assert that the assets of a bank must equal its liabilities. If they are smaller than the liabilities it means insolvency. In all the published balance sheets the liabilities are exactly equal to the assets. Assets[1] are usually concealed by not listing them or by crediting to cash, shareholder's deposit or issue or certificate of deposit to someone as trustee for stockholders or by undervaluing

[1] Liabilities also can generally be concealed by dishonest and designing officers in order to offset a shortage in the cash. But a vigilant and capable auditor can easily discover them.

the assets. This concealing of assets generally arises when heavy taxation is about to be levied on capital items. Secondly, the discouragement of competition might be the object, for a successful business would soon become the cynosure of all neighbouring eyes and invite competition from outsiders. So long as the insiders do not divulge the profitable nature of the business, competition may be warded off to a certain extent. If however the insiders are not loyal to the share-holders even this deliberate and artful concealment of assets would be of little avail. As has been stated already some of the assets like buildings are usually undervalued. So there is a hidden reserve in all these cases which becomes ultimately available to the creditors in case the bank has to be wound up.

It has been stated that the assets are duly marshalled in a balance sheet and arranged according to their usefulness and ready availability to the banker. Cash at hand, to continue the metaphor, is the firing line and call money is considered as the first support to the firing line. Discounts are considered as the next best and so on as explained on a previous page.

The effects of banking operations can be realised by noticing the ways in which the bank employs its money. The banks' method of employing money can produce far-reaching effects on the trade, the currency and commerce of a country. Banker's resources employed in discounting genuine trade bills would stimulate trade. If the banker were to finance production

and loans are granted to entrepreneurs for extending production the material well-being of the community is enhanced by the creation of saleable commodities. If loans are granted to persons out of trade or industry it would end in encouraging extravagance. If banks invest a large part of their money the price of securities will rise and the current market rate of interest would be lowered. If the banker were to keep idle his funds they would be of least advantage to the community and would yield no profit to himself.

It is better to take up first the profitable ways of employing the banker's resources in the succeeding pages because the banker is always anxious to utilise his money in one profitable operation or other even to the detriment of his very existence.

## Section 1.

### Call Money.

Call money—to give it its full name " money at call and short notice," is differentiated here from the loans and advances item of which it is a legitimate part.

Here, the money is lent for a period of three to ten days or in some cases it is borrowed one afternoon to be repaid the next morning and in this case it is known as 'overnight money.' Practically, though these loans are borrowed each day for the day only they are to a large extent generally continuous at varying rates of interest. This money is generally lent to

bill-brokers [1] and stock-exchange brokers who pledge sufficient high-class bearer securities to cover the loan, *i.e.*, consols, exchequer bonds, the debentures of Indian Railways and the bonds of the Corporation of London and the London City Council. The funds available for call money furnish an elastic margin in the bank's resources. In one important sense it regulates the bank's operations thus. If the demand for discounting bills is slack, these call loans furnish an outlet for funds which would otherwise be forced to remain idle. These loans can be recalled at any

[1] The bill-brokers are a peculiarly English institution and are very rarely met with on the European Continent. H. Withers divides them into two classes: the "running" bill-brokers who run from bank to bank selling and buying bills on commission and are always dependent on their clients for their funds; the discount houses are actual dealers in exchange buying and selling largely with funds of their own. These are about 20 in number of which the Union Discount Company, Ltd., the National Discount Company, Ltd., and Alexander Discount Company, Ltd., are incorporated.

The National Discount Company was established in 1856. The paid-up capital is £146,655. It has a reserve of £500,000. Its balance sheet of Dec. 31, 1920, shows a total of £32,405,636 worth of bills discounted of which £12,114,726 were sold to others. It paid a dividend of 24%. The Union Discount Company was established in 1885. It has a paid-up capital of £1,000,000. It paid a dividend of 28%. Alexanders Discount Company was established in 1810 and incorporated in 1891. It has a paid-up capital of £550,000 and a reserve fund of £270,000 and bills discounted amounting to £18,063. It paid a dividend of 28% on common shares and 12% on preferred shares. *Vide* Straker, "The Money Market," pp. 108-109. For recent information see the International Banking Supplement of the *Economist* or the *Statist*.

Both the bill-brokers and the discount houses in addition to attracting deposits for which they pay a slightly higher rate borrow heavily from the joint-stock banks.

time [1] by the banker that is whenever he sees a more profitable opening for their use or when money becomes tight. The borrowers have the right to repay it whenever they like but in the event of a call being made by the banker the money has to be repaid within twenty-four hours.

As the period for which the loan is made is short, the securities on which the loan is granted are first-class securities [2] and the borrowers have a good standing in the community, the rate at which the call loans are granted is very low, *i.e.*, 1 to 1½ per cent. It can never fall below ¼ per cent. because "it scarcely pays the ink, paper and labour necessary for making the entries in the books of the bank." But when speculation is rife or when there is a 'flurry' on the stock exchange call loans command a high rate of interest. As one writer says, "the trade conditions, the political and financial outlook specially the prospect of war or peace, the state of the foreign

[1] Though this is the theoretical conception still as a matter of actual practice it is "good money" lying in the hands of bill-brokers for quite a long time. As a recent writer puts it "its lowest level never falls even during a year which is visited by any extraordinary crisis, below two-thirds of its highest level." It has been calculated by certain people that the short-term funds loaned on the open discount market of London amounted usually to £150 ms. and it was generally lent at 2 per cent. below the bank rate.

[2] These are termed in banking parlance as "floaters." They float from one bank to another as one bank calls and another lends.

The practice in India is to lend call money without stipulating for any security. The interest demanded is however greater than in the case of loans made on security. This does not seem to be a good thing at least from the theoretical standpoint.

exchanges, the conditions of credit and the movement of gold to and from the country, make their influence felt on this short-loan fund of the money market or 'short money' as it is usually styled. History has recorded instances where the call money rate has reached a preposterous figure in the Wall Street.

| Call Money Rate. | Month. | Year. |
|---|---|---|
| 127% | Oct. 29 | 1896 |
| 186% | Oct. 18 | 1899 |
| 125% | Dec. 28 | 1905 |
| 15 to 25% | ... | 1919 |
| 15 to 20% | July to Sept. | 1929 |

The banker considers these loans as eminently satisfactory to him and reckons them as the 'first line of defence' because the pledged securities can be easily sold by him in case of the default of the borrower. Usually the discount houses that borrow call money run up to the Central Bank and obtain loans to discharge their liabilities to the banks and the market is technically described to be "in the bank." These lending banks have their cash at the Central Bank increased and their reserve position becomes strengthened. The borrower bears the risk arising out of the sudden call of the banker.

In the case of call money, the banker seems to accomplish the impossible feat of "having the cake and eating it too." Money lent in this form not only procures interest but the nature of the security is such that the banker can go to sleep with an easy conscience. He can realise the money at any moment he likes. The whole of the call money can be withdrawn by the

borrower from the bank but it is not usually assigned away by cheque as in the case of deposits and it is not generally used as means of payment.

A high rate for call money does not necessarily bring much profit to the bank because private individuals withdraw money from the banks and lend it to borrowers. A low rate of 2 per cent. brings in greater profits on the average and so some New York bankers have made it a rule never to lend money on call at more than 6 per cent. In normal cases there is excessive competition prevailing in the organised money markets. The commercial banks, the bill-brokers and the foreign banks—all compete with one another in the London Money Market to utilise their bank money at a profit. It is only when the nancial demand for credit is great or when the commercial demand is insistent that call money can rise to any appreciable extent.

The *sine quâ non* for this kind of business is the existence of a stock-exchange where brisk operations of buying and selling take place. It is this that gives employment for money obtained from the banker. The Wall Street in New York possesses a stock-exchange of a highly organised character and it draws the whole money of the U. S. National Banks to the New York financial centre. Its magnetic power travels beyond the borders of the United States and even the Canadian Chartered Banks employ a large part of their money in call loan operations in New York.[1]

[1] See Fisk, "The Dominion of Canada," the Bankers' Trust Publishing Company.

Coming to the Indian money market there were no call loans lent to any great extent even in the Presidency money markets. But after the war call loans are being freely lent and much interlending under this heading takes place between the different banks. One estimate of this total call loan fund fixes it at Rs. 5 crores. During the slack season or monsoon months call money becomes a "drug" in the market and some of the exchange banks prefer sending these funds out of the country. Of late, these are being invested freely in the Rupee Treasury Bills floated by the Government of India. In the busy season there is brisk interlending between banks and call money rates rise to 5 or 6 per cent. as the case might be. Usually they are lent at 1 per cent. below the Imperial Bank rate.

Call loans are not considered as good assets by many bankers. In normal times they may be reckoned as part of the cash reserve but in time of panic they become "frozen." These do not strengthen the banking situation to any extent. Lord Goschen says "money at call is a valuable asset" but it is not "an asset which constitutes a reserve useful to the general interests of the community at large."

The call loans in the New York money market strengthen the hands of those who dabble on the stock exchange. They do not facilitate the productive processes of the entrepreneurs of society. Besides the contraction of call loans checks the speculative tide and casts a repressive influence on general business. When call loans increase as in periods of seasonal dullness there is an artificial stimulation of

stock exchange speculation.[1] This self-same condemnation cannot be extended to the services of the bill-brokers who also utilise the " short money."[2] Just as the banks collect capital of short length in their hands and distribute them to producers, so also the bill-brokers convert the 'short money' into 'long money' and lend it to those employed in commerce.

In an organised money market private non-bank money is also lent as call money. In London, for instance, 50 to 60 per cent. of money employed as call money is other's money. When there is excessive call money of this description they undercut the bank's call money rate and the depressed discount rates naturally become more depressed as a result of this outside money contingent.

## Section II.

### Discount.

Discounting has already been considered as the process of laying down cash or ready money or creating present credits for a future claim. These claims are represented by bills of exchange.

An enthusiastic economist [3] realising the wonderful utilities and beauties of these bills has dubbed them " the most magical instruments of credit." A troubled Chancellor of the Exchequer[4] designated

[1] See J. B. Hollander, " Bank Loans and Stock Exchange Speculation " (National Monetary Commission Report).

[2] See the evidence of Sir Ernest Harvey quoted in the Macmillan Committee Report, p. 41.

[3] Hartley Withers. [4] Lloyd George.

them as "wretched, crinkled scrawled over, blotchy and frowsy pieces of paper." The usefulness as well as the danger arising out of the use of these bills will be studied in this section.

Bills of exchange are manufactured in the ordinary course of trade in this way. Suppose A has sold goods to B. There are several methods of paying B's debt to A. Firstly, B may pay cash, *i.e.*, legal tender metallic money. Secondly, B may pay in bank notes which are legal tender or Government paper money if issued by the Government. Thirdly, B may draw a cheque on his own bank balance and present it to A. Fourthly, B may draw a bill on D who may be previously indebted to him making it payable to A. Fifthly, B may execute a promissory note and thus postpone the matter of payment to a later date. Sixthly, B may hand over a cheque or promissory note or may hand over a bill of exchange which some other person has drawn to his *order* or *bearer*. Seventhly, B may buy from his bank a *cashier's cheque* and pay it to A.[1] The ordinarily approved method of payment in modern business transactions is by drawing bills, writing cheques or making promissory notes. Bills, cheques and notes form the major portion of the instruments of exchange in all economically progressive and forward countries. In France there is a very extensive use of internal bills of exchange and these are drawn even for sums of less than one hundred

[1] An excessive use of these cheques is made in the U.S.A. *Vide* Fisk, "Modern Bank."

francs. The French banks discount bills of such low denominations as five francs even.

A draws a bill on B payable after three months and in order to provide himself with cash sells it to his bank or bill-broker who before discounting gets it endorsed by A. If the bill is not accepted already by B, the bank or bill-broker [1] presents it for acceptance. B signs his name across the face of the bill and adds the word " accepted " and makes it payable at his own bank. The discounting bank deducts a certain rate of interest from the face value of the bill and credits the amount to A who may draw cheques for that amount. The discounting bank keeps the bill till maturity and collects it from B's bank which has already been intimated of that fact by B. Every customer as a rule has to inform his bank as to the acceptances for which he is liable and request the banker to pay them out of his account, so that the bill that has arisen out of the transaction takes the following shape.

*Bill when created.*

1000 Rs. Calcutta.

—— Stamped. *6th October, 1921.*

Three months after date pay to our order the sum of one Thousand Rupees for value received.

To B. A.

Bombay,
9, Theatre Road.

1 The "running bill-brokers" depend on the banks for cash and so they do not hold bills till maturity. A discount house possessing capital of its own holds the bill till maturity.

*Bill after Acceptance.*

1000 Rs. Calcutta.

—Stamped. *6th October, 1921.*

Three months after date pay to our order the sum of one Thousand Rupees for value received.

A.

To B.

Bombay,
9, Theatre Road.

Accepted.
B.
Payable at
A. B. C. Bank.

This is an *inland* bill of exchange.[1] As the commercial standing of A and B is fully known to the bill-broker he discounts the bill. This is first bought by the indigenous banker or shroff and sold to the big joint-stock banks or the Imperial Bank later on. The shroff's endorsement strengthens the bill and it becomes a first-class investment. All that the bill-broker or shroff has to remember is that the bill arises in the ordinary course of trade.[2]

[1] The term *hundi* is often used for the *remittance* bill of exchange in this country. Like the bill of exchange, they are of two kinds. The demand *hundi* is known as *darshani* hundi; the usance bill is known as *Muddati hundi*. It may be payable to *bearer* or a respectable person of the bazar known as *shah* or shroff or indigenous banker. All *hundis* are not mere business-like letters for ordinary payment of money. They contain unnecessary verbiage which includes greetings and request the party to pay the sum mentioned in the *hundi*. The sole defect of the *hundi* is that it does not indicate *the transaction* and the nature of the business out of which the instrument has arisen.

[2] Bills of exchange drawn for payment of goods or household expenses by private individuals indicate that the acceptor is short of money and has reached the end of his credit. Such bills are not easily discounted by the bankers.

If it is drawn against the normal course of trade as in the case of manufacturers on import merchants, the banker becomes suspicious and scents some danger. It is the importer merchant who must draw on the manufacturers for the goods he supplies and not *vice versa*. If it is drawn against the normal course there is some element of accommodation in it, *i.e.*, the import merchant has consented to accommodate the manufacturer for a mere consideration and in the hope that he would be repaid that amount before the bill matures. The bill then becomes an "accommodation bill." This is an excellent device to obtain money for some occasional purposes but no safe reliance for actual cash whenever it is wanted can as a matter of course be placed upon the bills. The discounting of an accommodation bill is nicknamed by the banker as "the flying of a kite."

The mere face of the bill does not indicate whether it is an accommodation bill or legitimate trade bill; hence it is hard to discriminate between the two.[1]

[1] Gilbart speaks of the following characteristics of the finance bills and says that if a banker notices these characteristics he should reject such bills. Accommodation bills are usually drawn for even amounts, for the largest sum that the stamp will bear and for the largest sum that the bank will discount and are presented for discount soon after they are drawn. The parties are often relations, friends or parties who from their avocations can have no dealings with each other. Sykes while commenting on this para. rightly says that "it is not wise to rely on these methods of distinguishing an accommodation bill for such characteristics are now too well-known. The best protection is to be found in a knowledge of the parties to the bill."

The well-known finance [1] bills have an element of accommodation in them. But these have ready negotiability on account of the high standing of the respectable firms which are parties to the bill. Again the vicious practice of "cross-firing" indulged in by people of high financial standing has also to be watched for carefully by the banks. Sometimes Governments make use of these financial expedients to raise money. Foreign banks [2] draw such bills on London finance houses and manage to live on this credit for quite a long period of time. Very often people speculate in exchange with the help of these finance bills.[3] The drawee firm should consent to be drawn upon or the same firm might draw on its London branch and in all these examples of "kite bills" the discounter of the bills cannot say whether accommodation is needed by the drawer or drawee or both. The discount market

[1] The proper thing is to draw a distinction between loan bills and finance bills and use the latter expression to denote long bills drawn by bankers or financial houses on banks and other financial houses for securing money which can be utilised by the drawer banker or both the banks (drawer and drawee). See F. Escher, "Foreign Exchange Explained."

[2] From the failure of the Bank of Egypt in 1911 it is plain that banks also indulge in "kite flying" as the technical name for the drawing of a finance bill is known. American banks make an extensive use of these bills and for understanding this procedure see I. B. Cross, "Domestic and Foreign Exchange," pp. 210-11.

[3] Suppose ready money has to be provided in London against sales of exchange but having bought "forward" some months or with the intention of buying at a later date the finance bill would be utilised to provide ready resources to meet the sales. Even banks habitually resort to this practice.

becomes more and more censorious when these finance bills are being drawn too frequently by the self-same parties. The modern banks refuse to discount at the same old rate too many bills whether drawn, accepted or endorsed by one and the same person. The firm which has too many of its creations in the market is much "talked about." A high discount rate also checks the volume of finance bills that can be created.

Another class of bills with an element of accommodation in them is the "anticipatory" bill of exchange. The Americans habitually draw bills in the first half of the year and finance their current outlay with these proceeds in expectation that in autumn real produce bills can be created to cover them. The anticipatory bill then mortgages prospective property in order to finance current outlay and an extensive use of these bills is made by agricultural communities like the people of the U. S. A.

Coming to the case of a foreign bill of exchange a concrete illustration of a commercial trensaction in Australian wool is taken up to enable the reader to visualise the actual process of its creation and grasp the manner by which banks finance commerce between two countries. Suppose the Australian wool is sent to England. Both the Australian and the English banks play an important part in the financing of this particular transaction. The Australian wool-grower sells his "clip" to the Australian broker who disposes it off to the Australian merchant. The Australian merchant ships it to England and sells it to an English merchant who in turn distributes it to the English manufacturer.

The Australian merchant when he ships the wool takes the bill of lading, the insurance receipt and invoice and attaches them to the bill of exchange drawn by him on the English merchant. The bill, with the documents attached to it, is sold to an Australian banker who remits it to his English agent. This English agent gets the bill accepted by the English merchant who makes it payable on maturity at his own bank. Usually the documentary bills are bought by the acceptor under rebate in order to obtain possession of the documents and of the goods. This is how international commerce is financed by the bankers. As a matter of fact, the banker's intervention is important at every stage.[1] The wool-grower depends on the banker for

[1] The Australian banker may finance the Australian merchant in the following ways :—

(*a*) The Australian banker may accept the bill and make it a first class bill, the merchant may sell it in the open discount market and realise cash for it or taking the bill as security loan money on it.

(*b*) The Australian banker may purchase the bill outright, *i.e.*, discount it himself.

(*c*) The Australian banker may discount the bill " with due recourse " in which case the bank reserves the right to return the bill to the drawer for payment in case of default on the part of the drawees.

(*d*) The Australian banker can take the bill as the collateral for a part of the loan made direct to the drawer of the bill.

(*e*) The English importer merchant might have authorised the Australian exporter to draw on the " home acceptance houses or home banks " by means of a confirmed letter of credit. English commerce is generally financed by means of these confirmed letters of credit.

(*f*) The English import merchant may have a credit with a home bank which has an Australian branch or correspondent and cash may be paid by them to the Australian merchant.

(*g*) The Australian bank may be acting on the advice of the English bank of the English merchant and pay the sum to the Australian merchants. The Australian bank collects the sum from the English bank which in turn realises the amount from the English merchant.

his advances to pay his labourers and it is only after the broker's payment that he will be in a position to discharge his debt to the banker. The broker again may be depending on his banker who finances him on the strength of warehouse receipt. The Australian merchant may buy the wool from the broker out of his own capital or obtain an advance from his banker which can be repaid when his bill is discounted by the banker.

The Australian banker who has bought the bill depends on his English agent to do the necessary work for him in England in getting the bill accepted and as soon as this is done he credits the Australian bank with the amount of the bill after deducting his usual commission charges. He realises the money from the bank of the English merchant.

*Specimen of the Foreign Bill that may be drawn in the above case.*

£1,000 Melbourne,

*The 6th October, 1921.*

Stamp.

Three months after sight pay this first of exchange (second and third of even tenour and date unpaid) to our order the sum of one thousand pounds for value received.

JOHN SMITH.
*(Australian Merchant.)*

To
JOHN ROBERT,
10, Carter Lane,
London.

When the necessary documents are attached it becomes a documentary bill.' The bill with the documents is finally lodged with the English agent of the Australian bank in London. Sometimes arrangements are made to deliver the documents to the importers so as to enable them to obtain control over the goods.

[1] The financing of commerce can thus be done in several ways and the procedure adopted would not necessarily be the same in each case. The banks must extend their accommodation to the exporter in the way he desires it and provide him with all necessary information collected by the foreign branch as to the state of trade and the standing of the foreign branch customer. In the case of all 'capital poor countries' their foreign trade is financed by the foreigners.

The financing of foreign trade is generally done by the letter of credit. If the importer wishes to secure goods he authorises the foreign exporter to draw a draft on his bank instead of on himself. The foreign exporter can liquidate this draft and the importer gets the goods by giving a trust receipt to the accepting bank and sell or manufacture them before he has to pay the bank. Herein the bank undertakes a contingent liability to pay the bill on due date were the importer to fail to pay it on maturity. But banks while undertaking this business safeguard themselves against the risk by taking certain collateral security.

The bill of lading, insurance policy, the invoice and the hypothecation certificate are used to obtain the goods as security.

The application for a letter of credit must contain (1) a request for letter of credit, (2) description of drafts, (3) description of documents, (4) description of shipment, (5) description of merchandise, (6) statement of expiration date. The terms 'irrevocable' and 'confirmed' are oftentimes used. Credit has to be further confirmed to the beneficiary through the agency of a second bank. In this case the importer specifies the bank which is to confirm the credit but this selection is left to the issuing bank who selects a solvent bank for confirming the credit.

But in this case " the dockhouse receipt " is placed in the hands of the English agent. When the importer has sold the goods he need not wait till the period of maturity of the bill. He can get the bill " retired under rebate." The rebate is charged at 1% above the deposit rate for short periods.

The chief function of the bill of exchange is to liquidate one's indebtedness and serve as a means of payment. These bills are negotiable and can change hands like the cheque currency through endorsements. Just as cheque currency is important for internal exchange transactions bill currency is important for international payments. Short-dated bills are fast becoming international currency.[1] These bills obviate the use of money just like cheques. Like cheques they can be crossed against each other in the clearing house. The exchange banker who deals with foreign trade transactions of the country buys the export bills on the one hand and import bills with the other. All the money needed for the payment of exports need not

[1] The bill of exchange was first developed by the Italian Commercial community in Florence. From thence its use spread through the commercial cities of Germany—the Rhineland towns and the Hansa League—to England. After the modification of the Law in 1882 bills are becoming more extensively used in the United Kingdom. But owing to changes in modern business organisation which tend to eliminate the wholesaler who is the chief user of the bill of exchange the number of genuine trade bills is becoming more and more restricted. Thus the universal tendency is for the bills to diminish in number as the unnecessary intermediaries in the trading chain of the community are being fast superseded.

be collected by the country. Only that amount which is over and above the cost of imports enters the country through the medium of the exchange banks. India is normally exporting more than what she imports. Besides paying the home charges some of the invisible imports have to be paid. Over and above paying these things something still remains to be sent to India. This is sent by the exchange banks in the shape of gold or silver bullion or they buy council bills in London with sterling and obtain the right to demand silver rupees from the Indian Government Treasuries.[1]

The second important advantage is the provision of cash to the drawer as soon as it is discounted by the banker. The seller of goods can liquidate this asset quickly by selling it to the banker or getting it discounted in the open discount market. The buyer of the goods also would be careful in making his purchases as he knows definitely the specific payments he has to make. The credit position of the buyer of goods would be improved if he generally accepts trade drafts for these can be utilised by the banker for rediscounting purposes at a low and preferential rate at the hands of the Central Banker. The continuation of trade processes without any break for want of ready money will be a significant advantage.

The third great advantage of a bill of exchange is to furnish an ideal investment to the banker. In

1 This action of the Exchange Banks financing Indian trade is studied more closely in my handbook "Present-Day Banking in India"—Calcutta University Publication.

the hour of emergency these bills can be easily rediscounted. Hence the bills of exchange form a good secondary resource. Bills mature within a short time. The documents attendant on the bill together with the Letter of Hypothecation which entitles the banker to sell the goods in case of dishonour of the bill furnish an ample security. Besides commercial morality dictates the paying down of these bills on the stipulated date without fail. As such the banker finds a profitable investment. About 20 to 30% of his loanable money is invested in these operations. Banks have separate departments dealing with this business. As a rule they discount bills for their customers only. Short bills are preferred by the banker. It is one of the banking axioms that "the longer the bill remains in circulation the greater will be the difficulty in obtaining payment." Many of the banks make arrangements with the bill brokers for a regular supply of these bills and the wisdom of this arrangement is unquestionable. These provide the banks with just the kind of bills that they desire—the proper amounts and maturities so that they may obtain the right types of paper. The Indian Joint Stock Banks and the Imperial Bank of India rely on the shroff who is the financial middleman in our money market. But there is not much of bill discounting in the organised money markets even.[1]

[1] Due to lack of genuine bills for rediscounting at the hands of the Controller of Currency the new expedient of borrowing on the strength of Government securities is not resorted to to expand the paper currency in this busy season (Feb., 1932).

The chief danger in the use of the bill of exchange lies in the fact that if the bill is not based on a legitimate trade transaction there is nothing but the credit of the parties behind it. If too many " kite bills " or " finance bills " are created and discounted there is the possibility that the expectations of the drawers and drawees might not be realised, in which case, they might be unable to pay back the sum and the banker would be a loser. These bills are based on credit and an improper use of credit is at any time possible. Even in the case of trade bills, there is an element of blank credit in them for the bank has to part with the documents and the goods at least ten days before maturity and it is true that a warehouse or trust receipt is granted but this is only a creation of lien and the understanding is that the money will be forthcoming at the date of maturity. Again several bills might be drawn against the one and same stock of goods. Production is not complete till the finished product reaches the hands of the consumer and during this intervening period the commodities change hands many times through several persons. If bills are drawn each time the commodities change hands several bills can be created and discounted on the very same stock of commodities. Thus there is danger even in the case of an ordinary trade bill. Again when commodities are not promptly sold the bill of exchange drawn against the goods is renewed and it may happen not once or twice but several times.

The rate of discount, that is, the rate which the

banker deducts from the face value of the bill depends on the demand and supply of bills. The banker has to invest his funds in the bills and the volume of money in the banker's hands constitutes the effective demand. Although the banker gives credit for the bill to his customer still he is precluded from creating too many credits. The dictates of prudent banking have to be respected and a certain proportion of cash to credit has to be maintained. The banker may wish to utilise his loanable money in other forms of accommodation, so the amount that is set aside for bill discounting is variable and the supply of bills increases with the demand as in the case of commodities.

The general state of confidence in the community, which is higher in active than in dull times, has an important influence on the price of these bills. The time for which the bill runs has to be taken into account. The longer the period the greater will be the rate of discount. The rate of discount is also intimately connected with the general rate of profit to be derived from the use of capital in the business of the country.[1] The possibility of any difficulty or risk making it impossible to collect the face value of the bill would have an important influence on the market rate of discount.

In England the market rate of discount is generally fixed by the three leading Joint-Stock Banks which have

[1] See my lectures entitled "Banks and the Money Market" delivered before the Calcutta centre of the Institute of Bankers, pp. 52-55.

the greatest amount of commercial deposits with them and all the lesser lights have to follow their lead if they wish to do discount business at all.[1] Even the Bank of England's discount rate is ineffective in normal times. The policy pursued is the one of maintaining a bank rate higher than the market rate of discount.[2] It is only when an unfavourable exchange situation has to be corrected, or when a drain of money to foreign countries is threatened, or when unhealthy speculation is being conducted with the help of banker's money that the Bank of England makes its rate effective and controls the money market to see that financial health is restored to normal conditions. The Bank of England has a discount policy of its own which aims at protecting the national gold stock. Even the co-operation of bill brokers would have to be enlisted to maintain sufficiently high discount rates in the market to make the bank rate effective at such times.

The commercial banks do great service to the traders and entrepreneurs by the discounting process. In order to render the greatest aid to them the rate should be low and it should be constantly adjusted

[1] The discount houses exercise some influence on the market rate. Their views on future monetary probabilities will certainly influence the current rate of the market. H. Withers, the English Banking System, p. 62, *et seq.*

[2] For a further discussion of the subject see my "Present Day Banking in India," 3rd Edition, chapter on the 'Central Bank of Issue.'

to suit the business needs of the community. This task of regulating the discount rate in order to benefit the community and also bring profit to the bank is by no means easy [1] and the banks have to interpret aright the business forces of the community.

The banks should be wise enough to arrange for a large number of maturities particularly on those week days in which business involves heavy withdrawals of money from the bank and fewer maturities on those days when there will be light withdrawals. The experienced banker knows when these periodical drains occur and be prepared to meet them with the help of these maturities. So the discounting business is quite a helpful one. It is not only a lucrative source of profits but it is quite an advantageous one as it strengthens the cash reserve. It is ordinarily regarded as a flexible secondary reserve of the bank. All that the banks have to do to strengthen their cash reserve is to stop discounting and collect the proceeds of the daily maturities of these bills of exchange.

Sometimes the privilege of rediscounting becomes an invaluable aid to those joint-stock banks which carry on their operations with small cash reserves. But the

[1] The alterations in the market rate and unnecessary raising of the bank rate specially, increase the cost of every kind of manufacture and therefore eats into the profits of the whole trading community. Money should not be made artificially scarce and dear without necessity. If it is possible to increase the gold reserve of the Bank of England without increasing the rate, it is seriously desirable that the Bank should take measures to do so. See the London *Statist*, May 19, 1900, XLV, p. 750.

English banks never as a rule resort to this except as the last recourse.[1]

That something is rotten in the bank is the usual inference drawn by observers who may be noticing the rediscounting process. It is considered as a sign of weakness. Besides the customers of the bank generally object to their transactions being made public by this rediscounting process. But the privilege of rediscounting is a very valuable help and no harm results out of it provided the banks discount first class trade bills arising out of *bona fide* transactions of goods.

In the absence of an ' open discount market ' and when there is no rediscounting privilege the commercial banks fall back on call loans as their immediate support to their cash reserve. But these lack the essentially self-liquidating character of the bills and should never be preferred to the bills. An open discount market also attracts foreign banks who may wish to employ their short money in foreign bills.[2] When the foreign

[1] When there is an unusually heavy withdrawal of money by the depositors or heavy demand for loans by customers no other method is open to the bank. In the English money market there is some aversion to this rediscounting business. But in the Continental countries the small banks habitually rediscount their bills. The London banks depend on call money for obtaining the necessary funds against any sudden pressure.

[2] A glance at the latest Banking Almanac will give one an idea concerning Colonial and Foreign Banks having branches or offices in London. As Mr. Hyde of the Midland Bank admits before the Macmillan Committee " that the total of the deposits that we have from foreign banks, the total money that is placed in London, that can be used in London is more than twice the total of all our advances and all our acceptances to foreign banks put together. So on balance we get a considerable sum that is being used in advances to home trade and home customers "—Q. 953. All this arises as a result of the organised discount market.

bills can be promptly turned into gold as in the case of the London Money Market and the sterling bills [1] the foreign banks keep a large number of these bills in their portfolio as part of their reserve. The United States of Amercia has recognised the advantages of an open discount market and has deliberately made provisions for bank acceptance and the discounting of these bank acceptances in their reorganised money market. Provisions for rediscounting facilities were also enacted. Such privileges would have been of invaluable aid to some of our solvent Indian Joint Stock Banks during the last banking crisis.

Commercial banks hold treasury bills if this form of short-term indebtedness on the part of the Government is presented by the financial policy of the Government. These can be turned into cash easily and banks generally are too eager to hold them. Indian commercial banks have not viewed the T. Bills floated at rather high rates as convenient and liquid investments. They have not become an 'integral feature' of the Indian money market as yet.[2]

[1] In spite of the suspension of the gold standard by the United Kingdom "all the North-European countries, India, Australia and Argentine, are still practically under sterling influence and the sterling circle may be extended in all probability." See Walter Runciman's speech in the House of Commons, Feb. 10, 1932. See my article "India and the New Sterling Standard," Calcutta Review, Feby. 1934.

[2] See my article on the Future of the Indian Joint-stock Banks, Calcutta Review. See also Appendix VI of my book "Banks and the Money Market."

## Section 3.

### Loans and Advances.

Under the comprehensive heading of loans and advances anything that the banker does in the shape of lending his credit can be arranged. Even discounting leads utlimately to lending the banker's credit and the discount rate might be defined as a charge for the loan of capital. But for better understanding of the subject the various operations should be specially studied. Hence call money and discounting bills are generally studied apart from the loan operations. This section deals with the banker's policy as regards overdrafts, personal loans and loans made on security.

Banks are not dealers in material goods. Their reserve may be obtained with " economic " capital but the chief feature of banking business is that ' economic ' capital plays a very little part. The essence of banking business is to grant mere promises to part with money at the present time for a promise that would mature in future time. In the matter of loaning the banks do not lend actual coin. What they do is the granting of the ' right to draw ' money to the borrower so the customer is credited with the loan amount. The customer is indebted on one side while on the other side he is credited with a corresponding amount. Thus a loan makes a deposit.[1] It is a book-transaction;

[1] Reginald Mckenna says, " Every new loan or purchase by a bank creates an equivalent deposit, thus increasing the quantity of money." See his Post-War Banking Policy, p. 5.

the creation of an asset and liability at one and the same time. The " active " deposits of modern banks are created to a great extent in this manner. Again the loan of one bank makes the deposit of another bank. A loan is the creation of so much credit which is utilised by drawing cheques. These cheques are paid by the borrower to his creditors who in turn may deposit them with their bankers. Thus the loan of one bank may become the deposit of another bank.

The loaning business is quite a profitable one for the banker merely lends credit. This credit is accepted by the community as the banker's name is quite a reputed and conspicuous one. The banks, however reputed they may be, cannot go on indefinitely creating credit because they have to keep cash to meet these 'demand obligations.' They must not reduce the proportion of legal tender cash reserve to such a ridiculously low extent as to threaten insolvency. As the late Sir Edward Holden has said, " the extent to which loans could be granted depended not upon the needs of trade nor the securities offered but upon the amount of legal tender reserves controlled by the banks."[1] The preponderance of loans means increased profits and huge dividends but this is not consistent with safety. It does not inspire the public with confidence who always expect a handsome margin between loans and deposits, a good cash balance and such first class liquid securities that can be immediately converted into legal tender money.

[1] Address to the Liverpool Banker's Association in 1907.

The danger to the banks or risk arising from their banking operations is very little, provided they take due precautions to secure the loans properly on first class or gilt-edged securities.[1] The following are some of the precautions which the banker should bear in mind. As the popular adage says, "all eggs should not be placed in the same basket." The banks should not lend too large a portion of their loanable fund to any single borrower. This is the well-known principle of distribution of risks which every banker should bear in mind. In some countries banking laws restrict the amount of loans that can be granted to any single individual or corporation to about 30 per cent. of the capital of the lending bank.[2]

The next precaution that the banks have to take is to judge aright the nature of the securities that can be accepted by them. The securities should be easily saleable and possess wide marketability. They should not easily depreciate. As George Rae says, "a perfect banking security should combine ultimate safety, a certainty of payment on a specified and not a distant date, a capability of being converted into money in case of unexpected emergency and a freedom from liability of depreciation." It is not the goodness of the security that is the prime consideration of the banks but the easiness

1 Mr. Bernard Shaw evidently is wrong in underestimating "the importance of loaning business as a mere minor detail of banking. It is not the retail hiring of money to ordinary tradesmen and men of business." See his Intelligent Woman's Guide to Socialism and Capital.

2 Such a "law" binds the American National Banks.

with which it can be marketed. Mr. Hobson does not realise this point when " he attributes the rise in the level of prices as due to credit granted by the banks. The increase of pledgeable securities makes it possible to raise credit."

The banks do not grant credit on any and every kind of security. It is not primarily the security alone that is considered by the banker but the slightest possibility or likelihood that he has to sell the securities to get back his money would deter him from granting the debt. It is not the quality of the security that is the criterion but the purpose of the loan.

The bank's primary duty is not to consider the security on which he can advance his accommodation. The banker has to bear in mind that he is not " to coin all kinds of unmarketable wealth into money nor should he undertake to convert into present purchasing power distant future means of payment." His sole duty is to finance the current transactions of the community. The failure to realise this was chiefly responsible for the breakdown of Law's scheme and the French Assignats of the Revolutionary period and the famous Continental notes issued by the Government of the United States of America.

Another precaution which the banks should bear in mind is that they should not accept too much of one single class of security as cover for a large loan. In the event of sale of a large batch of one class of securities, the banks may suffer by a big drop in price.

Another point for the banks is that they should be cautious in providing for a good margin in their favour. The banks should insist on the golden rule that the "less known a security is, the greater the margin." Normally, they insist on 10 to 25 per cent. margin according to the quality of the securities.

One more fact which the banks should remember is that the honesty, ability, financial standing and character of the borrower should be scrutinised even though sufficient collateral security is deposited as cover. The integrity of the borrower and his industrial capacity should be unquestionable. Every banker should remember the late Mr. J. P. Morgan's statement on the witness stand to the effect that "he would rather lend a million dollars to the man without a cent in assets but in whose character he had confidence than to a man with the opposite qualification." The banks should lend for productive purposes only and discourage loans for purely consumption purposes.[1] They should not allow the destruction of capital or an unproductive use of it.

Coming to the time length of the loans, the commercial banks should not make loans for long periods.

[1] This does not mean that consumption credit should not be created. The products of standardised mass production should not be left unsold as a result of lack of purchasing power on the part of buyers. The granting of loans to enable the borrowers to secure these goods will elevate the standard of living and keep going the modern industrial organisation unimpeded at its full strength. The prospect of easy repayment of the loan can be arranged in the manner the National City Bank of New York has done in this respect. But this should not be understood to mean that the planlessness of capitalistic economy should not be checked.

Loans should not be renewed in such a way as to become permanent loans because these very often end by becoming bad loans. A long loan practically releases banking credit which can increase the demand for goods and this is not counterbalanced by an immediate *pro rata* increase of goods on the other side. Commodities do not increase at once and as they are produced at the end of a long period it does not prevent prices rising through the extra expenditure undertaken by the banking credit granted by the banker. The other reason why banks should not grant long period loans is that they should not lock-up the demand deposits and tie up their resources in long-period loans. It would practically amount to investing money or at best lending it on mortgage. The banker's anxiety should not be as regards the rate of interest but the repayment of the original sum. It is not the banker's duty to lend permanently. As Stead says, " banker's advances are for the purpose of supplementing working capital only. They must never be allowed to become fixed." [1] Frozen long-term loans cannot be easily thawed in the case of an emergency.[2]

[1] F. Stead, " Banker's Advances," p. 129.

[2] Since the speculative crash of 1929 the banking system of America has been saddled with a large amount of frozen securities which cannot be rediscounted easily at the F. R. Banks. President Hoover is proposing the enacting of a bill to melt these loans by permitting these to be rediscounted out of the credit to be lent on the present " free gold " possessed by the F. R. Banking system to the extent of $200,000,000.

Theoretically speaking, bank loans are to be made for short periods and in actual practice these loans are made for a period of six months and they are allowed to be renewed so as to run for a period of two or three years, if not longer.

The banks shall, as far as possible, try to ascertain why the loan is being negotiated. As loans are usually granted to customers this is no difficult task. It is always advisable for the customers to take the bank manager into their own confidence and be frank with him. Not only can they be sure of accommodation then but they might also get his expert financial advice and general knowledge gratis. A bank manager is not a mere lender of others' money. He does not look upon his profession as a mere money-lending one. As Sir Felix Schuster says, " the bank manager does not specialise in one line only, he ought to know something of every business in the country." The bank manager can also decide what amount of credit is legitimate and justified for a customer to have and certainly grants it. He also withholds in case it exceeds safe and proper limits. As Dr. Reisser says, " the banks have to keep the amount of credit to be granted within reasonable bounds and to offer, as far as is within their power, the utmost opposition to an unsound demand for credit for financing hare-brained schemes. The banks must therefore endeavour to obtain at all times a comprehensive and accurate insight into the general conditions of the branches of industry and trade chiefly dependent on them for support in order to be able to

discriminate between necessary requirements and false hankerings after expansion and aggrandisement. They should be able to intervene or at least restrain and check in cases where the form and extent of credit received cause the fear of unsound development." The bank manager has to watch the intricate movements of both internal and international trade, the turn of political events, the rise and development of new industries and the new legislative enactments. To quote Sir Felix Schuster again, " he must know something about the movements of the world in general and above all he must be a student of human nature."

So there is nothing wrong nor is there any positive loss in being frank with the banker. On the other hand there is much for the borrowing customers to gain. The banker can be turned into a valuable auxiliary and expert friend who gives gratis the fruits of his wide and varied experience. It is always necessary to put a good and cheerful face to the banker and be sincere with him specially at the time of requesting loans. As one writer rightly says, " you can't talk to the banker like you do to the tax-assessor."

The bank managers should not commit the fatal mistake of " nursing accounts " with the vain hope that the borrower's business can be resuscitated and that the original sum can be recovered by timely advances granted afresh. Sometimes success may attend such a step and the stagnating business can be rejuvenated but very often this policy does not succeed

and banking literature [1] is unanimous in strongly condemning this practice.[2] The best and only way of dealing with bad debts is to honestly write them off. Turn out all that can be had by a sale of the securities used as cover for the loan and if the full amount is not recovered the loss has to be patiently borne. In the hopeless endeavour to recover this amount fresh sums ought not to be granted on the strength of additional doubtful security with which tempting bait the customer may try to entice the manager.

When loans are granted on securities, the banker should keep a vigilant eye on the market value of these securities and in case it shrinks, must properly notify the customer for fresh and additional security to cover the loan. Daily and hourly watchfulness of personal loan transactions is required and the bank manager must keep an unusually vigilant watch on the stock-exchange quotations specially of those securities on which he has based his loans and advances.[3]

[1] J. W. Gilbart writes, " We do not mean to imply that in every case it is inexpedient to ' nurse ' the account. This is frequently done with the best results, but the determination to attempt it must be governed by circumstances and in view of the fact as experience has proved that it is always a dangerous movement and the chances are always very much against the success of the result."

[2] C. A. Phillips says, " Repeated requests for renewals of loans generally signify carelessness or financial weakness or both." Bank Credit, p. 246.

[3] The relationship between the bank and the stock-exchange is a very intimate one. The bank mobilises the wealth of the community and then circulates it in an effective manner. But for the banker's mediation the locked-up wealth of the community denoted in its stocks and shares would not be turned into readily available purchasing power. Commercial banks grant advances and help the under-writers, syndicating agencies and investment banks to float the newly issued securities in the market and retain them till the period when the public ultimately absorbs them.

It is by loaning that a commercial bank confers the greatest blessing on society and its business. Herein the bank has the best opportunity to exercise its discriminating capacity in the economic organism of our society. It should exercise its judgment in choosing the particular borrowers to whom it can lend its credit. The strength and safety of the bank depends on the character of its loans. The critical ingenuity, selective capacity and discriminating ability of the banker is to be displayed in the matter of granting loans. The borrowers very often make impossible proposals and the successful banker is that one who can tone down the impossible proposal to an acceptable proposition. There is no use of merely driving out these customers to the arms of a rival bank manager who may deal more tactfully with the proposal. The bank manager should not necessarily accept every proposal for a loan after some necessary pruning. The banking standard must in no case be lowered. But the duty of educating the customers as to what the real requirements of the bank are lies in the hands of the manager. He should help the customers to satisfy these requirements and obtain business for the bank and grant accommodation to them. But after the advances have been made to the borrowers the bankers should always think twice before pressing them to repay the advances as it would seriously embarrass them. While he exerts pressure on bill-brokers and stock-brokers in the matter of repayment, the same attitude cannot be shown towards the ordinary borrowers. It is this

that differentiates the loan item from the call money item.

The bank managers should not place implicit faith in the popular doctrine that " cheap money makes business." If bankers were to make loans cheap businessmen would take more loans. Prices will rise and prosperity would be the ultimate result. Strong condemnation rather than a passing notice should be the meed of this alluring doctrine and specious half-truth. This argument is based on unsound premises. The businessmen would condescend to loan only if they see a profitable opening for the borrowed money. No sane businessman would borrow simply because money is to be had cheaply. When once the prospect of realising profits is assured the rate at which the banks would grant the loan is immaterial provided it is always lower than the anticipated rate of return from the enterprise. This is the psychology underlying the businessman's motive to borrow accommodation from the banks. Even speculators pursue this policy. As Albert Strauss says, " no rate however low will tempt borrowing for the purpose of purchasing a commodity whose price is believed too high and broadly speaking, no rate, however high, will by reason of its being high, restrain borrowing intended for the purchase of commodities which are believed certain to rise."

The lure of prospective profit whether it ministers to the cause of production or human good is the main criterion. Mr. Hawtrey who realises this says, ' even lending money without interest would not help if the

borrower anticipated a loss on every conceivable way that he could make use of the money.' [1]

Cheap money might facilitate the early revival of business activity but low interest rates maintained by the banks are not by themselves sufficient impelling motives which may lead to business revival. Hartley Withers puts it very ably when he says, "the price that enterprise has to pay for the use of money is only one among very many items that it has to consider when it is deciding whether to spread or take in canvas or just to keep her so, and it is a big assumption to suppose that by varying this one item a certain and prompt effect can be produced on industry's decision."

The abovementioned facts can be illustrated by a reference to actual history. During the business depression of 1873 and during the early nineties of the last century, the National Banks of the United States of America maintained 'rock-bottom' interest rates but there was no stimulus to borrowing by businessmen. The Federal Reserve Banking system deliberately maintained such artificially low rediscount rates as 1½ per cent. during the whole of 1930-31 period, with the fond expectation of checking the economic depression; but their experience was similar to that of the last century. With a 2 per cent. bank rate it could not stimulate the borrowing tendency on the part of the businessmen. From March 1920 to September 1922, there was a period of falling prices in England. Although the bank rate was reduced from 7 to 3 per cent. there was hardly any business revival.

1 R. G. Hawtrey, "Monetary Reconstruction," p. 142.

While it is possible to create even a panic by a sudden raising of the bank rate it is not so easy to induce business people to expand their business by merely lowering the banker's charge for the loan.[1] Too much is made of the potency of the bank rate and the ability of the bank to check trade fluctuations,[2] correct the situation of unemployment and attain stable prices. Every modern currency

[1] Prof. Cannan says "that movement of the bank rate as an expense in production is constantly very much overrated. The expenses incurred in borrowing money are only one of the numerous expenses in running any kind of business and in a great many they are not a very large proportion of it. They are not nearly so important constantly as other expenses. You talk about the poor builder being unable to build a house because the bank rate has gone up ; it may have been only a very moderate advance that he wanted for a couple of months perhaps and to pay 1 or 2 per cent. higher per annum upon that advance is not really a very serious matter. Not probably anything like so serious as a penny on wages."

[2] So long as trade oscillations arise out of natural or objective causes or are brought about by psychological errors of pessimism and optimism by the businessmen or are created by fluctuations of the price level or are generated by overcapitalisation of funds secured as loans from the bankers who pursue an unsound credit policy, or arise purely out of disequilibrium of saving and investment and the banks failing to act as a balancing factor, it is impossible to check the irregularities of investment in fixed, working and liquid capital, unless and until the banking system itself intelligently manages and promotes the investment tendencies in the right direction. It is indeed true that "the stimulus might come from outside the banking system" and if the monetary machine were to respond to the stimulus the trade cycles can never be checked. The banks can control the credit system to a great extent and by exercising proper influence on the investment factor control the level of prices and the fluctuations of industry. Banks might be doling out only short-term credit but through it it can influence the long-term rates and volume of investmen.

reformer and some of the modern economists dream of this possibility by having the discount rate altered in accordance with a definite policy laid down by the bank authorities and treasury officials. During normal times when the margin of profits is finely cut by competition prevailing in the market, a sufficient twisting of the monetary screw, *i.e.*, the raising of the bank rate by a few points, would bring about a fall in prices. There is again a psychological influence operating on the minds of businessmen as

Although there is a multitude of schools trying to explain the causes of industrial fluctuations, every one admits that the monetary machine becomes ultimately responsible for the amplitude of the cyclical fluctuations. But the banks cannot hope to check unreasonable credit fluctuations. The problem of economic stability is a wider issue than the narrower one of credit control. If economic or industrial progress is to be even and not undulating, the present unco-ordinated planlessness of capitalistic economy, regime of monetary profits, the profit-seeking entrepreneur system of production always outstripping legitimate demand and the faulty banking system which is sometimes responsible for changes in prices, have to be checked. Mere isolated action on the part of the Central Bank would be futile. It can secure a wise currency and banking policy which can check the amplitude of the cyclical fluctuations. Restriction of output and better production equating the supply to the demand after a proper understanding of the needs of the consumers and rationalisation of industry with proper diversification of the different types of industry, are essential to run the industrial machine in proper order. The contribution of the banking system to such an industrial economy would be the comparative stabilisation of prices and if points of disequilibrium were to arise now and then even the Government would have to aid the restoration process by a wise capital development programme of its own. The severity and intensity of industrial variations can be tackled by a joint effort of the bankers, businessmen, and the Government of the country. Mere credit stability by itself would not result in stable economic progress of society.

soon as the bank rate rises.[1] As Sir Charles Addis says, "a rise in the bank rate is considered by the business people as the danger signal, *i.e.*, the red signal warning the business community of rocks ahead on the course in which they are engaged. A fall in the bank rate is the green light indicating that the coast is clear and that the ship of commerce may proceed on her way with caution." The bank rate has a certain influence as a domestic monetary device and it can be reinforced by open market operations, moral persuasion, rationing and refining of credit at times, forward exchange rates policy and a wisely conceived gold buying and selling policy. These five-fold methods of credit control can hope to protect the domestic situation for the time being against the full brunt of the adverse international influences.[2] In spite of this it must be admitted that "prices and credit, industry and enterprise are not a pipe for bank rates fingers to sound what stop she pleases.[3]

From the bank's standpoint of view all loans are classified under the headings of (1) loans on stock exchange collateral, and (2) loans on commercial paper.

1 Prof. Dr. Edwin Cannan says, "It is the fear of disaster inspired by the rise that gives a kind of warning to the business world. The bank rate has gone up to 7 or 10 per cent. The idea is that the boom is coming to an end. "Where shall we be ? Prices are gone too far. We are not going to be able to sell, somebody else is not going to be able to buy. We must ask you to pay. And so you have all the things which cause people to think they must draw in."

2 The philosophy of Central Bank policy and many-sided weapons of credit control which may be successful in case they are intelligently exercised will be referred to in the chapter on "Central Bank."

3 See Hartley Withers, "Bankers and Credit." p. 172.

The banks prefer commercial paper mainly on the ground that these do not shrink in value. But it is unfortunate that the rise of big industrial corporations, specially in America, is reducing the supply of good commercial paper and a study of the loans made by the prominent New York banks reveals that loans on stock exchange collaterals are increasing. Even in England the bills of exchange are becoming rarer. Easton [1] says that " this is due to the development of cash sales encouraged by the co-operative societies." The development of the rapid means of communication and the perfection of the clearing house mechanism have immensely increased the payment of country cheques. The system of telegraphic transfers also dispenses with the use of these bills. Hence internal bills of exchange are on the decline while international bills are also being affected to some extent. These are not increasing in proportion to the increasing commercial transactions of the world. Such a decrease is indeed lamentable [2] because the banks are deprived of

[1] H. T. Easton, "Banks and Banking," pp. 216-219.

[2] Certain fundamental things are happening in the field of international exchange situation. Goods are being sold over the counter and cheque payment is becoming the rule. An increasing number of exporters are quoting the price of their goods in the terms of the currency of the importer instead of in sterling alone. But London is still the world's important foreign exchange market, for it is the greatest contributor of the world's foreign exchange. By means of its trade and services and its best organised money market in the world it is able to act as the world's foreign exchange centre and clearing house. All important foreign exchange banks must maintain a handsome London balance before they can hope to conduct foreign exchange business on a large scale.

first class investments which are not only free from the risks of depreciation but are easily and surely maturing on the arranged dates.

Under the heading of commercial paper are classified such overdrafts as are granted to customers, loans on promissory notes, the cash credits to customers and personal loans to big commercial people. Loans on stock exchange collaterals are granted to stock-brokers and bill-brokers and these generally run for short periods. If customers, on the pledge of securities, require the opening of a loan account, the banks also reckon this under the heading of loans on stock exchange collaterals. Banks granting loans on these securities resemble mere pawn houses—only the bank manager is not so cunning, depraved and demoralised as a pawn-broker. Again the banks wish " to fly " on the wings of commercial paper rather than confine themselves to the receiving of mere pledges whose bottom may be knocked out of them by unforeseen happenings over which the banker has no control.

Another classification of loans is according to the period for which the loans run, *i.e.*, short-dated credits or loans running from a single day, sometimes few hours, to 30, 60 on 90 days, *i.e.*, long-period credits or loans ranging from six months or more to years, as the case may be. The *raison-de-être* of the banker's policy in preferring short-dated loans has already been stated. It only remains to explain that long-dated loans for purposes of investment can be better obtained from loan and trust companies, savings banks and private banks which do not indulge to

any great extent in attracting demand obligations.[1] In England the promoters and financiers take up this task. The commercial banks should never condescend to degenerate into mere finance companies.

The economists' classification of loans is productive and consumptive. It has already been stated that the bankers can enquire into the object of the loan transactions and that banks have to encourage the productive enterprises of the country. It is not the business of the banker to grant consumption loans for sheer destructive purposes.

Coming to the study of the loans themselves, a promissory note is defined as " an unconditional promise in writing made by one person to another signed by the maker, engaging to pay on demand or at a fixed time a sum certain in money to or to the order of a specified person or to bearer." It can be made by two promissors in which case the liability will be " either Joint " or " Joint and Several." The promissory note is a negotiable instrument and the banks which loan money on such notes generally require two or more persons to endorse them. The borrower or promisor need not pay the loan until the end of the stipulated period. A loan on a promissory note is nothing short of a pure and simple personal loan transaction hence the banks wish to heighten the security of the paper by stipulating for two names to guarantee the payment on the paper.[2]

[1] It is these that furnish the needed capital in America for investment purposes.

[2] Then it becomes " double name " paper as distinguished from ' single name " paper.

An overdraft is the result of a previous arrangement with the bank manager, who on the strength of some security deposited with him, allows the customer to draw cheques for more amount than he has with the bank in his current account. Overdrafts are specially granted by the country banks which possess intimate knowledge of their customers. City banks consider the granting of unsecured overdrafts, arising out of miscalculation or oversight, as a bad practice for they endanger the safety of the bank. In times of stress these cannot be rediscounted and so they become unavailable in those cases. This idea of temporary overdraft financing by businessmen is disliked in America. Dr. C. A. Phillips [1] advises the American banks to consider overdrafts as an *exceptional privilege* to be granted only to *select borrowers* in *times of emergency*. Interest has to be charged and a request for prompt settlement has to be made immediately. Above all the policy of the bank should be to *advise the borrower to take an advance on note rather than depend on overdrafts*. Besides this firm and tactful policy in handling overdrafts strict supervision is always needed to check overdrafts. It has become almost an established working policy to consider large overdrafts as an " emblem of easy-going management and an inferior clientele."

In London the " Big Five " which control roughly 75 per cent. of the banking business of the United Kingdom make extensive use of overdrafts to very large

1 See Dr. C. A. Phillips, " Bank Credit," pp. 237-241.

firms on the strength of securities. To obtain an overdraft the head of the firm calls on or writes to the bank and advises it that it wishes to overdraw its account for a prescribed amount and the bank then honours cheques against it for approximately that amount. This sum is never rigid and the extent of the overdraft is left to be controlled by the requirements of the firm.[1] In American banking practice there is a great repugnance to the granting of overdrafts.

A cash credit is an advance on current account. Gilbart says, "a cash credit operates much in the same way as a distant account and a current account combined." [2] The customer is charged interest on the amount actually drawn. The customer can repay any portion of the borrowed sum whenever he pleases and, so long as securities do not become worthless or withdrawn from the obligation, the bank stands ever ready to support the borrowers' claims for credit provided they do not exceed the originally agreed limit. The prosperity of Scotland is attributed to this system by H. D. MacLeod who says, " Cash credit is to Scotland what the river Nile is to Egypt, a fertiliser." [3] This system is eminently suited to enterprising and frugal merchants who can obtain easy and cheap relief whenever needed. According to Leon Levi ' the Scottish banks have raised many a penniless struggler

[1] See Cross, " Domestic and Foreign Exchange," p. 64.

[2] G. W. Gilbart, " History, Principles and Practice of Banking," Syke's Edition, Vol. I, p. 195.

[3] See Adam Smith, " Wealth of Nations," Book 2, Ch. 2. See also the Proceedings of the American Banker's Association, 1902, p. 28.

to a position of competence, nay, of absolute eminence, by their system of granting cash credit to any individual able to offer a satisfactory security, even if it be no more than the guarantee of two respectable householders." [1] The success of the cash credit system in Scotland is attributed by Mr. H. P. Stringfellow [2] to its privilege of issuing £1 notes and he doubts seriously if the Indian banks would be in a position to make good use of this cash credit system, specially when they are not endowed with the similar privilege of issuing notes.

Separate loan accounts are sometimes opened by the customers and whenever a part of the sum is to be used it is transferred to the current account of the customer. The customer has however to maintain a balance in the loan account. Hence the banks grant a lower rate than that on overdrafts.

Personal loans are sometimes made to customers merely on the strength of their commercial standing and commercial success. Carlisle says, "personal security takes account of other things besides actual possession but the main consideration in connexion with it is for all that the amount of the man's total wealth of every nature. This fact points to the conclusion that the real meaning of banking with the apparent creation of capital that it involves, is the bringing of the more or less undefined wealth of the world into the field of immediately

[1] Leon Levi, "History of British Commerce," p. 287.

[2] H. P. Stringfellow, "Notes on Banking Practice in India," 1898. Thacker Spink & Co.'s publication.

available purchasing power." [1] To every bank there are certain honest customers who take a keen interest in the building up of its business and it is entirely a wrong and suicidal policy to incur their resentment and displeasure by refusing loans wanted by them. Such loans are demanded in very rare emergencies and it is in the interests of the banks to grant unsecured loans to such powerful allies and customers whose personal character is of an unimpeachable standing.[2]

Loans secured by mortgages are sometimes made by commercial banks but as T. Hankey, a practical bank administrator, says," the bank should realise the enormous difference between a bill of exchange and a mortgage." A loan on mortgage of real estate is not allowed by the banking law of several countries but the wisdom of securing existing loans by taking additional security in the shape of mortgage of real estate is unquestionable.

It is not to needy customers alone that modern banks lend their money but impecunious and improvident Governments depend on the invaluable aid of the banks for their business. The success of a loan

1 W. Carlisle, " Monetary Economics," p. 170.

2 The Indian Central Banking Enquiry Committee has done substantial service in pointing out the necessity of making "personal loans" always remembering that character is one of the three bases on which banking loans are to be based. The very first banking concern of India known as the *Earliest Bank of Bombay* (1720-1783) did not suffer any loss on any of its personal loans. See my " Organised Banking in the Days of John Company," p. 353. Indian banks have to realise that " honesty, even if stupid, is a better foundation for credit than the most adroit finesse."

floatation is chiefly due to bankers helping their customers to subscribe to them. In India, it is the banks and the big merchant bankers who habitually absorb the treasury bills [1] that are annually floated by the Government of India.

The management of the Government public debt and the floating of temporary as well as long-term loans on its behalf is usually the business of the Central Banks. The Governments of all capital-poor countries used to float their loans in the London money market in the pre-war days.

London was not only the "World's clearing-house" for foreign bills, the only free market for gold, the hub of international commerce, the world's greatest centre of re-export trade, the greatest and important international security market, but also the chief loan centre of the world. Though this financial machinery still exists in London the economic situation arising out of the trade depression and the suspension of the gold standard [2] point out a declining trade, unbalanced

[1] The minimum denomination being Rs. 5,000 the sum is too big for small individuals to subscribe or invest. In as much as these are repaid within 3 to 12 months they have the character of commercial loans behind them. So the banks take in a large portion of the treasury bills.

[2] J. M. Keynes says in a recent speech, "The pre-war gold standard worked because it was in truth a sterling standard. When gold went off sterling last September it doomed itself as a currency at least for the time being. We have been forced, it is true, to step down for the moment from the position of international leadership in finance, but our place has not been taken by anyone else and I feel confident that unless we lack the pluck we shall soon be strong enough to revive our old position with the heightened prestige of holding it in virtue of having surmounted present difficulties."

budgets, reduced financial earnings under the well-known option the "invisible exports" of the country.[1] The heavy average annual drain of interest payments to America has almost weakened her economic position. Until the reparation debts and the inter-allied indebtedness problem are satisfactorily settled Great Britain has to pay from 1933 till 1984 an average annuity of £38,000,000 to the United States of America. The economic future of Great Britain is bound to progressively decline as a result of high wage costs, vicious taxation, withdrawal of foreign balances, comparative industrial ineptitude, the relative over-valuation of the pound sterling as compared with the undervaluation of many other currencies, the practice of international deposit banking on the part of the London money market, unemployment, foreign competition in neutral markets, stereotyped high money rates, excess of long-term foreign investment over what is available from the balance of payments and direct uneconomic outlay on the part of the State as well as individuals. The National Government has been endeavouring its level best to remedy this deplorable situation and it cannot be stated that her re-organisation of her key industries, a protective tariff, low money rates and empire economic unification policy have been enabling her to regain her prosperity.

The present economic position of the U. S. A. should be grasped clearly. It has nearly half the world's gold

[1] Income from foreign investments, shipping charges, and banking and insurance commission has declined while the adverse balance of trade is still persisting (January, 1932).

supply and more than a third of the world's wealth. It has become " the ultimate creditor nation, the world's chief money-lending power and the world's richest treasure house." The U. S. A. has undoubtedly become the world's economic centre. It has become the most portentous industrial rival of Great Britain. It has many millions of people endowed with acute intelligence and a high average of activity and efficiency. High wages, high salaries, big profits, low costs of production and high prices of commodities enjoyed for a period of eight years (1920-28) brought in the *New Era* of whirlwind prosperity in America. The recent payment of international debt, the import of gold and the development of the discount market are features which have attracted the attention of all banking and trading circles. The New York banks are endeavouring their level best to popularise and universalise the dollar bill. Some of the American banks are opening branches in foreign countries. The American banks realise that the system of foreign branches of the English banks has secured to England her control over foreign trade. Realising full well that " trade follows the bank " the New York banks are anxiously extending their foreign branches not only to finance their own export trade but to acquire the financial leadership of the world. International security markets are being developed as healthy adjuncts to an international discount market. Considered as " an important part of Uncle Sam's equipment for his new career as a world banker " every effort is being made to perfect the technique of

the stock exchange markets.[1] Reorganising her own banking system the U. S. A. is pushing her economic and trade activities vigorously in the Latin-American countries, Central Europe, China and the Far Eastern markets. Carl Snyder[2] says that America's total trade is possibly greater, measured in money transactions, than that of all the rest of the world put together. From the beginning of this century the U. S. A. bankers have been trying to be the world's financial centre.[3] To achieve this they have attempted at first to become the granary and the workshop of the world. Next, they have developed enormous capital resources and until 1928 pursued systematically the policy of foreign investment.[4] Though she has not been playing the rôle of a creditor country in an intelligent manner and the coincident circumstances have been favouring her till 1929, she has been vainly striving to displace London as the world's clearing-house, loan centre and financial storehouse. But several things are needed to enable America to become the real money centre of the world.[5] The debtor countries must be allowed to

1 See the Annals of the American Academy of Political Science, Vol. 82, p. 347 and the following pages.

2 See his Address to the American Academy of Political Science, Annual meeting, 22nd November, 1929.

3 See F. W. Hirst, "Wall Street and Lombard Street," p. 160.

4 During the years 1925-28 the U. S. A. invested roughly £1,000 millions twice as much as Great Britain did during the same period.

5 Both Dr. Paul Einzig and Dr. C. A. Phillips point out these deficiencies. The get-rich-quick craze has to be subordinated. The adaptation of a financial market to international conditions is a long-drawn-out process. Sir Joshiah Stamp says that the Americans have a

repay the payment of interest and capital in the shape of merchandise. She must continue to observe the rules of the game of the international gold standard and lend the gold holdings to the needy borrower countries.[1] Of all the great economic powers the U. S. of America and France [2] are on the gold standard basis, but gold

fundamental fear of international responsibility and a naive faith in their ability to prosper regardless of the rest of the world. This spirit of financial isolation and tendency to hoard gold will militate against America's ability to act as international financier.

[1] For the " rules of the game " of the international gold standard see the English translation of the article of Prof. Gustav Cassel, January, 1932. Quarterly Report of the Skandinaviska Kreditaktiebolaget, Stockholm. Firstly, there are economic conditions, *viz.*, the abolition of abnormal impediments to international commerce and international movements of capital, the renunciation of unreasonable demands for transfer of capital in connection with war debts as well as short-term credits granted by private lenders; and some willingness to grant loans to make up deficits in the international balance of payments. Secondly, there are monetary conditions, *viz.*, the utilisation of increasing stocks of gold for increasing the amount of money in circulation and thus raising the level of prices—a condition which also involves the renunciation of unreasonable demands for gold cover, as a preparatory step to the immediate abolition of all statutory enactments regarding minimum gold reserves. Hence " an international gold standard is under the present conditions impossible."

[2] France is now becoming the final depository of gold and it holds the future of the gold standard in its hands. Though the tendency to accumulate gold is being weakened as a result of the lessened balance of payments in her favour (1932), the giving up of the transubstantiation of assets by the Bank of France (1931), and the abandonment of the position of French banks to convert their foreign short-term amounts into gold are still holding " francs " as a safe gold currency and new gold is being poured out of hoards only to be incarcerated in the French bank vaults. Unless dishoarding of note currency takes place and the French price-level is influenced by gold movements, the equitable distribution of gold as in the pre-war days will not be forthcoming. The main problem facing the French banking system (1932) is the stimulation of the investment habit both at home as well as abroad.

is being held in such large quantities by them that it has become a veritable poison.[1] The Senate Banking Committee have at last recommended the creation of additional credit on the basis of " free gold," held by the F. R. Banks. About $200,000,000 of gold would be released and " industry and trade might receive the much needed fillip " say the economists. It must not however be forgotten that " banking action necessarily follows and does not lead industry." [2] If non-monetary factors contribute towards industrial revival monetary action might tend to sustain it and perhaps undoubtedly accelerate the conditions of revival. A revival of international prices is the much needed adjustment of help that has to be secured both to the debtor as well as the borrower countries. It alone can make the wheels of commerce go round again in an exhilarating manner.

## Section 4.

### Investments.

Broadly speaking, the bank's operations of buying discounts and making loans can be considered as only different methods of investment and creating credit.

[1] Lord Bradbury aptly observes that " under the gold standard, gold in quantities which can be digested is a food, in excess it becomes a poison. The system ought to be worked in such a way as to leave to other nations what they require for food not to take it and these have to lock it up so as not to be poisoned by it."—See p. 271, The Macmillan Committee Report.

[2] Prof. Henry Clay.

It has been said already that commercial paper is preferred by the banker to loans on stock-exchange collaterals. These are preferred to loans on the staple commodities and real estate. This virtually is the order of the commercial banker's preference but reference will be made in this section solely to the bank's holding of gilt-edged investments.[1]

A commercial bank is always haunted by the nightmare of its total "demand obligations," unless it makes use of its credit and the cash that is entrusted to it there will be no profits. It is forced to make its investments of such a liquid character as to be within its beck and call. So it takes care to employ its funds in such a way as not only to yield profits but see that they are at the same time safe. Absolute strength and safety are required by the bank. Hence it invests its money in such first class securities which are easily marketable with the minimum trouble and risk of loss. No bank holds all its investments in one kind of security, be it a Government security or not. It distributes its funds among several securities of first class character or gilt-edged securities which can be easily sold when a large amount of ready cash is needed.

Strictly speaking, a bank investing its fund in public loans or Government securities is not carrying

[1] It is indeed inexplicable why the Bank of France is forbidden by law to hold investments. The antideluvian policy has to be changed as early as possible so as to permit the Bank of France to control the French money market. See my Lecture on the French Banking System before the Indian Institute of Bankers, Calcutta Centre, December 1933.

on a banking operation. The business of "a bank is to circulate capital, not to lock it up." The bank is forced to employ its funds in these investments not by virtue of any great productiveness of this kind of business but because they are capable of easy realisation in the event of any unforeseen and large demand on the part of the depositors of the bank. Investments are not so profitable as discounting or loaning. Only in the event of a possible rise in the value of the securities is there any chance of considerable profit to the bank. This does not mean that the bank should speculate in the value of these Government stocks and shares with the view of making profit. But the creation of gilt-edged securities which can be sold in any financial centre is giving scope for the banks to take advantage of changes in the price-level of these securities at the various centres. They begin to operate on their own account. A bank should sell securities only in the event of a pressure as a means of strengthening its cash reserve to meet urgent demands. It should always publish its amount of Government securities in the balance-sheet so as to inspire confidence in the minds of its depositors.[1]

Another important question to be noted in the case of bank investments is the advisability of investing in foreign Government securities. The pre-war

[1] Even the Bank of England publishes separately its holding of Government securities from the other securities.

practice of the French banks[1] was to prefer Government securities of inferior states noted for industrial impudence, financial ineptitude and political instability to any home industrial securities. It was this preference that led to the investment of French savings in Russia, Austria-Hungary, Turkey, Bulgaria, Servia, Morocco, Mexico and Brazil. The banks always desired a high rate of interest and hence their partiality towards this kind of investment. Again the French citizens with their thrifty habits always accumulated large savings which could not be wholly absorbed in industrial undertakings. Hence the surplus deposits were invested in foreign lands. Another reason responsible for this practice was the centralisation of banking in France. There was concentration of savings in a few banks and these banks found it easier to follow the budgets of Governments rather than the changing balance-sheets of industrial companies. The deep-rooted caution and conservatism of the French people are to be contrasted with the speculative habits of the English people and on account of these peculiar financial traits there was a wide resort to foreign investments. Prof. B. M. Anderson says, " The direction of French investment has been subject not to the free movement of capital sent piecemeal under competitive conditions by alert investors to those lines of investment which promised the best yield for a given degree of safety but has

[1] Owing to the loss of milliards of francs by France as a result of Russia's repudiation of debts the present-day French investors are fighting shy of foreign long-term loans.

been controlled by a few great banks working to a large degree in harmony acting for a passive body of depositors and controlling public opinion through the press."[1] This large holding of foreign investments by banks or financial houses or rich individuals should not be mistaken as an indication of the real economic prosperity of the country.[2] A nation is economically rich only when it has industrial enterprises which can develop production.

The practice in European Continental banking is to lock up funds in ' participations ' as they are styled in France by the *French Banque de affairs*. The German banks hold industrial financing as their main business, for " mixed " banking is their ideal. Consequently a large number of industrial participations form part of the total investments of these banks.[3] These industrial companies have been virtually created by the banks and they retain some control over the company by holding a large number of shares in their hands. It

[1] B. M. Anderson, " Effects of the War on Money, Credit and Banking," p. 38. The French Moroccan War of 1925 was due to the endangering of the vested interests of finance by the rising of the Riffs and the economic desire of exploiting the numerous resources of Morocco was the chief cause of the colonial war.

[2] M. Ribot says : " A great nation does not live on interest and dividends from foreign securities. It lives on labour and industry. The extent of foreign investment is a deceptive measure of a nation's riches. Not an abundance of capital which it can export but a support of enterprise which develops the means of production, is the measure of a country's riches." Quoted from E. M. Freidman " Labour and Reconstruction in Europe," p. 35.

[3] See the Memorandum on Commercial Banks, League of Nations publication, p. 135.

generally happens to be the case when banks begin to do underwriting business for industrial companies. Even some of the English banks do this underwriting business for colonial and foreign Government issues of loans. The chief dangers of this policy of excessive investments abroad in foreign Government loans or industrial participations are the uncertainty of profits to the bank and any depreciation of the value of the industrial shares would reduce the value of the bank's assets. A banker, while making his investments abroad would have to increase dependence on the correspondent bank and the possibility of watching the progress of the institution is denied. A close connection between Government and finance should exist. Besides these facts it must also be understood that the foreign policy of a country is largely shaped to a certain extent by the investments made by the financial interests of the country under the persuasion of the banks.[1] National wealth, honour, security and the rest would be endangered by the wars.

[1] M. Poincare declared in 1912 that his ministry strove to combine with French military and naval power as converging and connecting forces, and enhance the financial power which is so great an aid to France. M. Caillaux avowed in 1913 that he admitted to quotation "only those foreign loans which assured France political and economic advantages." See H. Feis, Europe the World's Banker, 1870-1914.

The following cynical poem truly reflects the situation :—

*A Song of War.*[1]

The Banker sat in his parlour
And chuckled aloud with glee ;
He raised his glass,
His wine he quaffed,
For War is declared, said he.

The soldier shouldered his rifle
And fared him forth to the fray;
His pulse beat high,
He smiled and sang,
For War is declared to-day.

The people awoke from slumber
To answer the clarion call,
They flew to arms,
No cost too great,
For War is declared for all.

A woman sat and mourned alone,
A child cried out for bread,
A trader watched his ruined shop,
For customers were sped.

A workman wearily sought a job,
But factory wheels were still
And men lay dead and dying,
On distant plain and hill.

But—
The Banker sat in his parlour
And chuckled aloud with glee ;
He raised his glass,
His wine he quaffed,
Thank God for the War, said he.

[1] Quoted from L. Envoi.

Finally, the main reason why the commercial banks should think twice before they undertake such a course of action as participation in industrial securities and excessive investment in foreign Governments' loans is economic in nature. The primary duty of a commercial bank is to bridge the economic distance between the savers and the borrowers of capital and to provide cheque currency which would automatically expand and contract in consonance with business requirements. The rôle of company promoter is not his. A banker with short-period debts and long-period assets is a danger to society. If a banker were to saddle himself with blocks of securities which may prove either unsaleable or capable of realisation at a heavy sacrifice only, he would be courting danger. Hence it is always prudent for a banker to see that his assets consist of automatic and self-liquidating bills, short-period advances, or securities and suitable gilt-edged long-term investments to a limited extent. As the late Mr. G. H. Pownall, an English banker of repute, has said, " the commercial banker should not be a partner " in any industrial undertaking. The banker has to invest his money wisely but not speculatively.

### The Proportion of Total Investment to Assets.

If the banker's criterion for the selection of gilt-edged securities is their prompt convertibility, freedom from loss and the yield of a stable rate of interest, the question what proportion of funds should be invested remains to be considered. But no *a-priori* rule can be

laid down prescribing this proportion. The usual convention is that an amount equal to the capital and the reserve fund is invested in interest-bearing securities. The paid-up capital and the reserve fund do not belong to the public and so that much of bank's funds cannot be recalled by the shareholders. They serve as a guarantee of the bank's solvency. Much more than this can be invested but it all depends on the general stability of the bank itself and the degree of confidence it inspires in the minds of the people. "Age as well as honesty helps the prosperity of the bank," says the economist and an old and well-trained institution need fear nothing in investing on gilt-edged securities so long as these are paying a commensurate rate of interest.

But the commercial banks should remember that at times of panic even Government securities are unsaleable. "At the time of 1866 panic even consols were unsaleable." [1] That has been the experience in every country in troubled times of political insecurity and turmoil. In normal times of peace and tranquillity the gilt-edged securities may materially strengthen a declining cash reserve but these do not constitute, in any sense, a real banking reserve available in times of panic. Besides there is the risk of depreciation attached to even first class securities. In the case of short-term commercial bills there is no depreciation in their value. The bank receives the amount which has been advanced. In addition to this it can make

[1] Patterson, "Science of Finance," p. 223.

arrangements for daily maturity of these bills and hence this discounting businesss is a far safer and flexible thing, augmenting the resources of the bankers at the required time. Mr. Samuel Gurney says, "it is my judgment that to a banker a good supply of bills of exchange of first-rate character is a better investment for his funds for which he is liable to be called upon on demand than Exchequer bills or any Government security.[1] "

Hence a very tactful handling of investments is required. It is always safe and advisable to keep real liquid legal tender cash involving some sacrifice of profits rather than court danger by investing too much in first class securities with a view to secure profits. The incarceration of legal-tender money in the reserve might be deemed unbusinesslike or foolish but it should be considered as an inevitable insurance premium that it has to pay against a possible collapse of its credit superstructure.

Coming to the time length of the investments which banks have to make, it should be realised that long-term investments are subject to indefinite capital depreciation. Hence short-term investments alone can be selected as the banker has to realise the uncertainty of value attaching to long-term investments. Even though temporary depreciation of these securities is a danger and proper provision has to be made for this, still the amount written off will be returned within a few years when they will be redeemed. If

[1] See his evidence before the Parliamentary Committee on Joint-stock Banks, 1836, Q. 2614 and the following.

the securities suffer a depreciation in value the funds of the banker are depleted and the general solvency of the banker would be jeopardised.

Most of the Central Banks can have dealings in Government securities, *i.e.*, buy and sell securities and hold any investments without any legal restriction.[1] By buying securities credit is granted in its books and the deposits of the commercial banks begin to expand. The volume of credit thereby expands. By selling securities the Central Bank tends to cancel credit. This is the *modus operandi* of the Central Banks' open market operations as they have been technically termed. Even in the antediluvian banking system of France there is resort to a somewhat similar expedient as this. As the Bank of France is forbidden by law to hold investments, this new monetary arrangement by which credit can be created is conspicuous by its absence. To enable the Bank of France to control and regulate the money market " Bons de Caisse " in place of the Russian Treasury Bonds of 5,930,000 francs are placed in its hands by the Caissa de Amortisement. These securities can be negotiated on the market when it deems desirable to control the money market. The bank can buy back the bonds negotiated before maturity. The difference between the sale price

[1] The british banks had to face a serious situation as a result of heavy depreciation of gilt-edged investments. Their policy of covering the depreciation by drawing on the *inner reserves* saved them. If current profits are meagre the only sensible course is to cover the depreciation by drawing on the inner reserves. See the *Banker*, February, 1932, p. 120.

and the buying-in price would be at bank's own risk. Without such authorised dealings in securities and bills to supplement the bank rate and acceptance activities of the Reserve Banks, the total volume of Reserve Banks' credit may not be successfully and properly adjusted to the needs of the country. [1]

## Section V.

### Acceptances.

What constitutes an acceptance has been explained in the section on discounting. It only remains to explain why banks have taken up this task of accepting bills on behalf of its customers.

Acceptance means the creation of an obligation to pay according to the terms of the acceptance. So the bank when it accepts a bill is obliged to pay the value of the bill at maturity. The customers of the bank usually make it a practice to settle what amount of accommodation is to be granted to them by the banks in the shape of accepting the bills and paying them in case of need or in the shape of overdrafts or loans on securities which they deposit. Up to that agreed limit which generally depends on the turnover of the customer's business the banks accept the obligation of paying the bills if that is the pre-arranged form of accommodation. This is usually done by the buyer or importer securing the bank's promise to accept bills

1 See the Report of the Banking and Currency Committee of the Chamber of Commerce of the U. S. A. on the F. R. System, 1929.

for a certain sum or issue a "commercial letter of credit" for that purpose. The customer later on pays the amount and liquidates the debt to the banks. Hence this acceptance business does not constitute any real menace to the banks. The banks know the business standing and business stability of the customers and as they accept bills for them they know that they will be repaid that amount. Commercial banks sometimes agree to form "acceptance syndicates" to float an issue of acceptances for a customer if the finances needed by him outrun the capacity of the individual bank.[1]

The conventional practice is that the customer must put the banks in a position to meet the bill at maturity.[2] So no cash of their own need really be paid by the banks. They lend their own name and credit to guarantee prompt payment of the bill and thus strengthen the standing of the bill.[3] For this useful service the banks charge a commission of 1 to 1½ per cent. This is how the banks derive profit from their acceptance business.

[1] See T. J. Kavanaugh, "Bank Credit Methods and Practice," p. 78.

[2] In some cases collateral is also deposited with the banks by the party on whose behalf the acceptance is made.

[3] Technically speaking the real guarantors of the bill are the endorsers. The bank or the acceptance house which has accepted the bill is the debtor and being the acceptor must pay the bill on maturity. By means of this acceptance system banks finance industry and trade. If large firms do not give or accept bills but conduct business on open trade credit or bank cash credit the bill habit cannot arise and no acceptance business can be developed.

Originally this function of acceptance was specialised to a great extent in the London Money Market by big merchant houses of commanding reputation and wealth. By accepting to pay the bill at maturity the hitherto obscure bill drawn by unknown parties obtains prominence and easily becomes negotiable. There is also a slight lowering in the rate of discount at which it will be discounted on account of the acceptor's strong name. Hartley Withers says " the bill becomes hall-marked for purposes of currency " and a vast amount of bill currency is thus created by these acceptance houses. The banks which discount these bills have thought it wise to check the power of these acceptance houses to accept too many bills or worthless and spurious bills. So the banks themselves have taken up this task of acceptance and in the London Money Market many of the banks derive handsome profits out of this business.

The commercial banks accept bills drawn against goods. This is not however the case with acceptance houses which accept bills drawn against finance transactions. These are known as finance bills. As the commercial banks accept bills drawn against goods the advantage to the customer is this. The actual owner of the goods does not hesitate to trust the customer because the bill is accepted by the customer's bank and this bill can be sold in the market easily and at a better rate than would have been the case if the bill were not to be accepted by the bank.

The advantages of bank acceptances are the easy financing of borrowers who otherwise have to obtain a

loan on pro-note or on securities. The banks without spending a single pie of their own finance the transactions of their customers by " swapping the less known credit of their customers with their own well-known credit," as one American author puts it.[1] The banks may also find profitable occupation in first accepting the bills of their customers for commission and then selling them in the open market. Bank acceptances, *i.e.*, bills of exchange accepted by banks, are ideal short-term investments and so long as the accepting bank's credit is unquestionable one need not bother about the standing of the drawer or other endorsers of the bill. Fine bills or bank bills are discounted at a lower rate than trade bills drawn on obscure trading firms. " The most meticulous holder can put these gilt-edged bills into his portfolio and sleep on soundly."[2] In Europe bank acceptances are widely sold to banks, corporations and individuals as short-term investments.

By means of the acceptance credit the London banks and acceptance houses are annually taking a heavy toll from other countries.[3] By virtue

1 H. P. Willis, " American Banking."

2 Hartley Withers. " Money Changing," p. 100.

3 Mr. J. M. Keynes estimated the total volume of acceptances before the War at £ 350,000,000. In 1912 England was financing Germany by accepting business to the extent of £30,000,000 a year. There are at present two classes of acceptance houses. Firstly, there are those limiting themselves to acceptance and doing consignment business. Secondly, there are those houses which conduct acceptance business along with foreign exchange work. While the business of the first class is dwindling that of the second class is on the increase.

of the facts that the London Money Market in the pre-war days was the only free market for gold, that the trade of the United Kingdom extended far and wide, that the London banks and acceptance houses were doing business of a strictly legitimate character and as there was much of expertness in the London financial machinery due to their specialisation and as these financial agents eschewed all speculative tendencies, the sterling bill became international currency eagerly sought for in paying off the debt between two trading countries other than the United Kingdom or the possessions of the British Commonwealth. Chile and China mutually settle their obligations with the help of the sterling bill and London obtains something for its services as an intermediary in this transaction.

With the outbreak of the Great War the acceptance business of the London banks and the acceptance houses came to a standstill. Foreign trade bills could not be discounted as usual in London.[1]

[1] From the last week of July, 1914, to the middle of August the discounting of foreign bills and acceptance business was entirely suspended. It was only towards the end of August that the British Government assisted the London financial agencies to discount and accept foreign trade bills as usual, but as the value of the sterling began to depreciate it became an unsatisfactory medium in which future contracts for payment could be made. The pegging of the sterling towards the latter part of 1915 restored confidence in the sterling to a certain extent. Till 1919 however the acceptance business of the London Money Market did not reach its normal proportion. The following table shows the growth of the acceptance business :—

| Business. 31st December. | Amount. £ | Income. £ |
|---|---|---|
| 1914 ... ... ... | 50,770,000 | 12,688,000 |
| 1915 ... ... ... | 65,831,000 | 15,061,000 |

This dislocation of business led to complete disorganisation of the foreign exchanges between all the money markets. As gold could not be remitted in payment of their obligations the London acceptance houses found it difficult to conduct their business as before. The value of the London acceptances became doubtful and this fact is primarily responsible for the complete transformation of the American methods of financing their foreign trade. American bankers had to enter the field of foreign exchange, accept foreign bills of exchange and organise the financial machinery needed to handle its vast foreign trade.

American banking law before the passing of the Federal Act in 1913 did not permit this acceptance business [1] and the Americans had to pay annually good round sums for the financing of their trade. Under the Federal Reserve system acceptance has been recognised as a legitimate banking function

| | | | | | |
|---|---|---|---|---|---|
| 1916 | ... | ... | ... | 74,336,300 | 8,505,000 |
| 1917 | ... | ... | ... | 70,630,000 | 7,700,000 |
| 1918 | ... | ... | ... | 65,080,000 | 5,550,000 |
| 1919 | ... | ... | ... | 161,095,000 | 96,015,000 |

The increase in 1919 was due to the resumption of overseas trade and it reflects to a large extent the increased prices of commodities—A. W. Kirkaldy, "British Finance." Sir Robert Kindersley points out that London acceptance houses conduct their business with foreign funds deposited with them. London thus gets profits without having the necessity to divert English capital to the financing of foreign and possibly competitive business. See his evidence before the MacMillan Committee.

[1] Paul M. Warburg's paper "American National Monetary Commission Report."

and the nature of the bank's domestic acceptance has been clearly defined by the Federal Reserve Board Circular No. 19 (Nov. 29, 1915).

The rediscounting of the acceptances of the National Banks which are members of the F. R. System is allowed up to a certain limit.[1] Bank acceptances are becoming popular in America and there is an encouraging demand for them as short-term investments. During 1920 the F. R. banks discounted $187,162,000 worth of banker's acceptances for member banks and purchased $3,143,737,000 worth in the open market. But for the fact that there is the daily settlement in the Wall Street bank acceptances would have multiplied to a great extent. The demands of the Stock Market can be reduced to a certain extent by adopting the term settlements as in the case of the London Stock Exchange.

It is only a financially strong country that can afford to undertake acceptance business on a huge scale. Acceptance houses should have international standing possessing intimate knowledge of the financial standing of the business [2] firms in other countries. Mr. B. M. Anderson says, "Acceptance

1 Federal Reserve Board Circular No. 18, July, 1915, and May 6th, 1921.

2 Sir Robert Kindersley rightly says, "Acceptance business requires a very great deal of watching, a very great deal of travelling and a very careful study of world conditions and it is the chief business of the partners of any acceptance house."—Macmillan Committee Evidence, Vol. I. p. 72.

houses are a sort of international Bradstreet and Dun." The main difference between the two is that acceptance houses do not like the latter give out their information. After a thorough examination of the business standing of the commercial firms they undertake the risk of accepting their bills. The banks would take up easily the accepted bills of these houses. It is not the bank alone that acts as the risk-bearer in this operation. They are helped to a large extent by the acceptance house and there is a scattering of the risk between the banks and the acceptance houses. Here the bank is only instituting its own wider and well-established credit for the narrow and unknown credit of the trader. Here as elsewhere the business of banking is to substitute its own credit for the less-known industrialists and agriculturists.

The important question as regards the aggregate amount of acceptances which a commercial banker can undertake remains to be stated. The total volume of bank acceptances must bear a definite relation to its resources.[1] The common practice of the English acceptance houses is to accept bills up to three times the amount of their capital. Those bankers and acceptance houses which specialise in this business accept bills many times over

[1] Sir R. M. Kindersley says, "The self-imposed rule in the acceptance business is to accept 3 to 4 times the limit of capital plus Reserve." Macmillan Committee Evidence, Vol. I, p. 73.

and above their amount of capital.[1] When smaller Indian Joint Stock Banks are empowered to accept bills there ought to be some limit imposed on their ability to accept trade bills. Without acceptance business there can be no discount market. Without a discount market and a central rediscounting agency as that of a Central Reserve Bank there cannot be bank acceptance. It is this vicious circle that has to be confronted. But in the enthusiasm to develop bank acceptance business no misuse of this form of bank credit should arise in the initial stages as it was the case when it was first developed by the Continental banks.

The Indian shroff combines in himself the duties of the bill broker and an acceptance house though he does not specialise in the latter function. He buys the bills from traders about whose standing he has no

[1] Paul M. Warburg, "The Discount Market in Europe," p. 11. The American National Monetary Commission Report. He repeats the self-same point in his "Federal Reserve System," Vol. II, p. 634: "We should be very careful not to impose an excessive load of liabilities on our large deposit banks. Institutions often having deposits amounting to more than 10 times this capital and surplus and having invested a large portion of those funds in commercial loans involving credit risks, should consider very seriously whether it would be wise for them to add to their existing commitments acceptance liabilities in excess of certain figures, unless indeed the general deposit liabilities are kept within very conservative limits. Where the deposit liabilities do not exist banks might accept up to a liberal multiple of the capital and surplus. A pure acceptance bank without deposit might accept up to a high figure."

See also Phillips, "Bank Credit."

doubt. In case he has sufficient funds he holds the bill or "hundi" till maturity. But very often during the busy season the 'hundies' are rediscounted in large numbers by the Imperial Bank. The Imperial Bank is only concerned with the standing of the shroff and the other names are not of material importance in its choice. The Imperial Bank buys the bill because like the acceptance house the shroff makes himself liable for the bill and thereby enhances its security and makes it a gilt-edged investment. There is not direct and technical "acceptance" as in the case of the acceptance house but all the same it is nearly equivalent to acceptance. Just as the English acceptance houses make a special study of its customers so do the shroffs of the Indian Money Market. Both have important financial standing. Both of them perform helpful service in getting the bills discounted in the money markets.

Many of the shroffs of the Indian money market have as good a standing as the best acceptance houses in the London Money Market. Just as the helpful intervention of the acceptance house is necessary for the bill to be discounted at a low rate in the open discount market,[1] so also the shroff's endorsement is absolutely

[1] The work in the London Money Market is so complicated that specialisation is advocated in the interests of its customers; hence there are bill brokers, acceptance houses and promoting financiers each specialising in a particular business. In India, however, all these functions are performed to a large extent by the shroff. So long as the Imperial Bank is worked by a foreign staff the standing of the indigeneous trader can

necessary for the discounting of the " hundi " by the Imperial Bank. Even when rediscounting becomes a settled habit as soon as the C. R. Bank becomes established, nothing is more important than the insistence of rediscounting three name paper alone, one of which should be that of the bill broker, or acceptance house or a bank signature.

never be accurately ascertained without the help and advice of the shroff. Shroff's houses can easily develop acceptance business. Acceptances Associations can be created in places where branch banking is not developed. Agricultural co-operative sale societies can easily draw bills and get them accepted by these Acceptance Associations and so long as the primary products which form the base of the bill are stored in licensed warehouses there is absolute security for the acceptance house. As these accepted drafts travel from one money centre to another they form a connecting link between the different centres. It is only by this cautious method that the much needed inter-linking between the isolated up-country centres and the organised money centres at the ports can be formed on a satisfactory businesslike basis.

# CHAPTER V

*Sec. I. The Dead Stock*—Bank building.

*Sec. II. Cash Reserve.*—Definition—its object—The "touting" for business. Banking regulations—their ability—Banking practice with reference to C. R. proportion—Data for fixing the proper cash reserve—immediate convertibility of assets—Caution—"Window-dressing" balance sheets—The national reserve—A large amount of gold in the C. B. Reserve—The English banker's "Psychological Reserve"—The national character of the English people—Regulation of the C. B. Reserve—Pre-war practices—Wise administration of the bank rate—Wise credit management—Social needs—Prompt adjustment of the rates of interest to social and productive needs—Monetary causes for crisis—Unemployment as a result of monetary maladjustment—Banker's duty to check the unduly large variations in the money unit.

## Non-profitable Assets.

After a study of the profitable undertakings of a commercial bank it remains to pay attention to the non-profitable operations of a bank among which the Dead Stock and the Cash Reserve of a bank have been pointed out as the principal ones.

## Section I.

## The Dead Stock.

The Dead Stock includes the bank building, office furniture, fittings, stamps, and stationery and these are absolutely necessary for the purpose of carrying on the

business of a bank. They are " dead " in the sense that money sunk in these operations does not yield a tangible profit to the bank. In the event of failure all these effects can be sold and realised for what they are worth by the creditors of the bank.

The bank building must be adequate in size and imposing in appearance. It should provide sufficient convenience to its customers. It must have carefully constructed vaults to hold the cash reserve. There should be good storage room for old records and documents' files. The building should by all means be decent in appearance, but any undue extravagance in providing these quarters is not advisable. The bank building should always occupy a first-rate site. Good premises attract good customers for the " World is still deceived by ornament." The banks have to generally occupy the first floor of the building and let out the other floors which would bring in good rents. The bank's policy should be to write down the value of the premises and an allocation from the gross profits for this special purpose is an advisable thing. It is always preferable for a bank to have solid cash in its hands rather than invest it in brick and mortar.[1] It may reduce the profits of the bank. The building should be burglar- and fire-proof to a large extent. Fire insurance is a wise precaution which should in no case be neglected.

[1] In the state of Wisconsin (U.S.A.) only 25% of the capital and surplus of the bank can be invested in the bank building.

## Section II.

### Cash Reserve.

By cash reserve is meant the provision of lawful legal tender money for the payment of any unusual and extraordinary demands of the depositors. The cash reserve is an " insurance fund against risks." [1] As Bagehot says " it is a safety fund." It is the foundation of all credit that can be created by the bank.

At the risk of wearisome repetition it must be said that the commercial banks have numerous " demand deposits " which have to be paid. As a guarantee of performance of this task a generous cash reserve has to be maintained. In order to earn profits, part of the bank money has to be invested in quick and easily realisable assets. The cash reserve must be large not only to satisfy all the unusual demands but should enable the bank to provide additional facilities whenever required by the public. The ban k should not only take care of itself but must be actuated with a genuine desire to serve the needs of the public and minimise any financial strain whenever it occurs.

The commercial bank is naturally actuated by a desire for profits.[2] The excessive competition that prevails among the several banks, forces them to reduce their cash reserve to the breaking point, or ' danger line' as some economists say and, ' apprehension limit ' as Bagehot would style it. This 'touting' for profits is

B. M. Anderson, " The Value of Money."

[1] From the bank's standpoint of view " reserve is dead money and makes no contribution to dividend," says Prof. Foxwell.

all the more marked and may be felt in a country where general banking regulations do not exist.

Banking theory does not prescribe any rough and ready proportion of cash reserve as against the total liabilities of a bank. It only emphasises the importance of a sufficient cash reserve to the several individual banks and advocates the study of cash reserve from the viewpoint of the banking system as a whole. National solvency is no less vital than individual solvency. But in some countries the legislators have fixed certain proportions to be observed by the banks in the actual conduct of their daily routine business. 'Competition,' they say, ' tends to reduce bank reserves to the lowest limit endangering the safety and liquidity of the banks.' In the endeavour to garner profits no heed would be paid to the proportion of the cash reserve which has to be maintained. Hence arises the necessity, say the legislators, to fix the porportion of the cash reserves.[1] Many critics point out the sheer inutility of these regulations as it makes the reserve useless when it is most urgently needed. As one writer observes, " an iron ration which you must not touch even in the throes of starvation is something of a mockery." [2] This argument does not state that the bank should not be made to keep a reserve against its demand obligations. Only the law should be wise

[1] The National Banks of the U.S.A. had to maintain cash reserve ranging from 15 to 25%. The Federal Reserve Law has modified this legal limit. Careful elasticity and not dull rigidity is the present day aim of the banking regulations in the matter of the cash reserve.

[2] D. H. Robertson, ' Money.'

enough to permit the free use of the reserves under certain emergencies, provided that efforts are made to replenish the reserves at the same time. The stopping of fresh discounts is usually stipulated by the banking law whenever the cash reserve touches the legal limit. Some regulations go a step further and prohibit any declaration of dividends to shareholders until the due proportion is once again restored.

These laws certainly help amateur banks and may keep under restraint the ' adventuresome banks ' which wish to spread sail and provide for the storm when it actually descends upon them. Beyond this their efficacy is questionable. More reliance has to be placed on the honesty, wisdom and discretion of bank officers than on banking laws to regulate the reserves. According to Hartley Withers it is " good bankers and not good laws that conduce to sound banking." A cool head, sound judgment and a resourceful mind can efficiently regulate the cash reserve by alternately selling securities for cash and loaning cash on securities. A prompt adjustment of the discount rate will secure a better management of the cash reserve than a mere automatic and rigid adherence to mechanically created legal regulations. A legal limit tends to make the reserve inelastic. It fails to protect the banks in any absolute manner. Besides a sense of false security is the result of a legal limit. The bank thinks it has done everything it has to do by keeping the prescribed legal limit of cash reserve. It does nothing to check the inflation of credit which is the sole cause for the draining away of the reserves. In the absence of

such a law the bank in its own self-interest keeps adequate provision, for it realises full well that successful banking is largely dependent on a proper management of the reserve. Banks like all other businessmen are disposed to fear the dread of bankruptcy and this urges them to self-protection. This instinctive force is the mainspring of all their activity.

If banking theory is silent on this important point and if banking law fails to give us any true indication of the right proportion of the cash reserve to liabilities attention must be diverted to banking practice. Something may be gleaned out of this. Banking practice has demonstrated that what is adequate to-day for any bank need not be adequate for it the very next day. It points out that banks in a manufacturing country keep a different proportion of reserve than banks stationed in agricultural tracts. Banks stationed in densely populated areas where exchange transactions are frequent and numerous keep a different reserve than banks in out-of-the-way places. Banks usually make provision for a higher cash reserve during the busy season than during the slack season. Banks which have few but large customers keep a higher cash reserve than banks with numerous small depositors. Banks doing business with those communities where the cheque-paying habit is thoroughly established keep a lower reserve. Banks which have fluctuating deposits as those of the stock-brokers, keep a higher reserve. In unsettled countries where matters are in a confused and disorganised state and in a perpetual flux the banks

maintain a high reserve. Thus the cash reserve of a prudently well-managed bank has to vary with the seasons of the year, the character of the customer's business, the activity of the accounts and the business habits of the customers. After all experience is the best guide in this all-important matter of a proper cash reserve.

A calculation of the proper cash reserve cannot be done successfully till due account is taken of the habits and wealth of the people and the character of their business and public sentiment on this subject. As Bagehot says, " the intensity and the amount of the liabilities " should be properly weighed.

This ratio of cash reserve arrived at after some years of general experience affords a better guarantee for the conduct of successful business than any *a priori* mathematical or numerical ratio prescribed by legislators. The average ratio for each bank is quite different from another's and to impose mechanical uniformity in the matter of the cash reserve by banking regulations is only to court failure or minimise the efficacy of the cash reserve itself.

If everything is to be left in the hands of the practical bank officers and to the nicety of their judgment in the matter of regulating cash reserves, then they must realise what a real reserve is. The too often prevalent notion that sound and liquid assets constitute part of the cash reserve is erroneous. In times of panic these liquid assets become 'frozen.'[1]

[1] Another distinguished banker, T. Hankey, says, " the Bank of England knows that there may be moments of sudden alarm when no one is willing to part with ready money on any terms whatsoever."

As the late Sir Edward Holden said, " Even call money cannot be relied upon."[1]

Cash, hard cash is the only reserve. The bank should aim at ' immediate ' convertibility of its assets into legal tender money. Immediate convertibility is the criterion and unless this is the case the assets cannot help the bank officers. Cash alone can be useful to the bank officers at all times and all hours. A reserve must be available to the banks and a locked-up reserve as in the case of banks regulated by laws is not available to the banks in the hour of need and its existence can safely be ignored. As one economist says, " if gold in the reserve is not available the gold can as well be in the mines." [2] Nobody can deny that this locked-up gold is a good asset but it is only available when the bank closes its shutters and goes into liquidation. The bank's cash reserve is after all intended to prevent that very liquidation and if it fails to prevent it, it defeats the object of its own existence. If call money, sound and liquid assets and locked-up reserve do not possess the coveted feature of ' immediate availability ' it is apparent that the banks cannot rely too much on these supports.

[1] Some of the London Joint-Stock banks consider call money as part of the reserve and add both the items together in their balance-sheet under the heading ' cash in hand and at call.' But during the periods of 1890 and 1907 crises call loans could not be recalled. The banks must know full well that a re-calling of these call loans during the times of a crisis would only make matters worse and precipitate the catastrophe.

[2] Prof. H. S. Foxwell, " Papers on Current Finance."

The provision of a sufficient cash alone can stave off bankruptcy.

The banks must realise that it is better to err on the side of caution and provide a large cash reserve thereby making a part of it idle rather than be adventurous with a smaller cash reserve. The banks should not rely on their ability and " management to muddle through somehow " as Lord Rosebury puts it. To avoid failure is far more important than to heap up high and precarious profits. As Bagehot says, "adventure is the life of commerce but caution, if not timidity, is the essence of banking."

The pernicious practice of " window-dressing " balance-sheets is resorted to by some of the 'adventuresome banks.' The accommodating power of the banks is curtailed during this period and the businessmen will suffer on account of such contraction. After all it is not a source of strength to the bank because the loans will again be granted as soon as the balance-sheet is published. It is only a deliberate attempt to mislead the public as to the actual strength of the bank as denoted by a high proportion of cash to liabilities maintained at the time of the publication of the balance-sheet. Sir Felix Schuster says that ' window-dressing is not after all an evil ' because ' there must be something to dress the windows.' So long as there is this ' something ' there is no harm to the bank, says he, but what about the customer's inability to secure loans. It is always preferable to stand on the firm ground of gold and

silver rather than have resort to such dubious tactics as " window-dressing."[1]

The subject of the cash reserve has thus far been discussed from the standpoint of the individual bank but the national reserve, *i.e.*, the entire reserve of the banking system of the country, must be adequate. Individual bank reserves are wholly dependent on the national reserve. As banking business is becoming more and more organised and as the individual banks have learnt to lean on the Central Bank for support in times of pressure, smaller reserves are being kept by them.

There is a real economy of gold not only in the actual circulation but gold is economised to a great extent even in the outlying banks. " The real art of banking consists in the economy of gold," says the economist, and the individual banks should pursue this ideal with great warmth indeed, but the last place for any such economy is the Central Reserve. In the Central Reserve or one reserve system as Bagehot[2] calls it the cash reserve ought to be large enough to

[1] The recent Macmillan Committee rightly condemns this vicious and euphemistic practice of window-dressing on the part of " the Big Five " of the L. M. Market. See paras. 368 to 370. The true daily averages are rightly insisted upon by the Committee.

[2] Bagehot prefers the ' many reserve system to the one reserve system' but the latter has been too widely established to be altered at present. Even from the standpoint of theory it is difficult to accept Bagehot's conclusion as regards the merits and the advisability of having the " many reserve system." In the " many reserve system " each bank would be subject to separate drain and hence the reserve has to be large. In the one reserve system the maximum drain is to be felt upon the sum of these banks collectively. Hence a smaller reserve is necessary.

procure the freest mobility of banking credit. It should be large enough to enable the Central Bank in times of emergency to rediscount the commercial paper originally bought by the joint-stock banks. While the ordinary banks have facilities to borrow from the Central Banks the latter have no such borrowing resources thrown open to them.[1] Hence the necessity for larger cash reserves on their part. Just as in the case of the individual banks no definite proportion of cash reserve against liabilities can be suggested, so also in the case of Central Banks the magnitude of the cash reserve should solely depend on the economic activities of the country, its financial position, the superstructure of credit that is raised by the banking system as a whole and ' the psychological reserve ' that it can depend upon.

The English banking system in spite of the fact that it transacted the banking business of the universe worked on the smallest cash reserve in the world. As Hartley Withers says, " English bankers work with a ' psychological reserve.' " As one American writer puts it, " it is because the English bankers are so safe, so straight, so sensible, from an American point of view so unenterprising, that they are able to build up a bigger credit fabric on a smaller gold basis and even carry this building to a great height which they themselves have decided to be dangerous." This ' psychological reserve ' is a priceless asset that has been handed down

[1] The creation of the Bank of International Settlements has however changed the situation.

through generations of good bankers and "every individual of every generation who receives it can do something to maintain and improve it."

It is not the conspicuous ability of the sound bankers alone that enables the English banking system to conduct its operations in the most economical, efficient and least costly manner by having a small amount of gold as the cash reserve. It is chiefly due to the national character of the English people. Leon Levi pointed out this fact long ago and compared "the staid and self-possessing character of the English people with the impulsive disposition of the Irish. The Irish are constantly alternating between the extremes of confidence and distrust. At one time they will avail themselves in a most inconsiderate manner of any facility of credit. At another and immediately as credit is in any degree checked they fall into a total want of confidence. In Scotland a sound public opinion respecting the currencies operates rather more efficiently than any bank restriction Act in economising the use of gold. A person who asks for gold in payment of a note acts in the eyes of the community in a most unpatriotic manner and contrary to the interests of the country. In Ireland the great body of the peasantry have upon the slightest rumour a desire to possess themselves of gold in preference to paper." [1] The inference is clear. If certain favourable changes take place in the national economy of the country a lower reserve would be as efficacious as a

[1] Leon Levi, "History of British Commerce," 2nd Edition.

higher one and would go far in winning the confidence of the people. Banking efficiency would also enable the bank to get on with reduced reserve ratios.[1]

The ordinary method of regulating and protecting the individual reserves of the bank is futile in the matter of protecting the national reserve. Quite a new method is pursued in the latter case and again each country has its own peculiar method. In England the Bank of England formerly tried to protect its reserve by effective changes in the rate of discount. [2]

Dr. Agger's suggestion is now no longer to be relied upon for it is the gold *bullion* standard that is now operative and not the gold *specie* standard. The light weight coins that did not come within the legal

[1] C. A. Phillips says, " certain changes taking place in the evolution of our economic organisation, such as improvements in transportation facilities, quickened means of communication, the centralisation of banking reserves and the creation of improved rediscount facilities admit of reduction in percentage of reserve ratios. Any condition tending to reduce business losses such as the thoroughly organised credit department, and new and strict forms of bank supervision go far in eliminating the necessity of making poor loans in the first instance. Hence a marked evaluation in the reserve ratio can also be secured."—p. 100, Bank Credit.

[2] " Even in England it is now realised that the fall of the discount rate is least effective just when the reserve is least effective," says Prof. H. S. Foxwell, Papers on Current Finance. Formerly it was held that a " 10% bank rate would bring gold even from the bowels of the earth." But now it is realised that the bank rate has no such influence on the movement of gold. Owing to the extraordinary nature of our times it is said that a " 10% bank rate will not bring gold even from the moon." A raising of the London bank rate now means the increase of the short-term liabilities as international deposit banking is pursued on a large scale.

limit of tolerance but exceeded it were cornered in a chest once in every year after the " Trial of the Pyx " and demand for exportation was usually satisfied out of this " gold export corner." [1]

In pre-war Germany the Reischbank viewed with displeasure all proposals to export gold and this Imperial displeasure was a sufficient preventive.[2] The Bank of France always maintained a premium on gold for export purposes varying from 2½ to 6 per mill (¼ per cent. to 6-10 per cent.).[3] Besides this measure it protected its huge reserve by taking shelter under the legal clause permitting it to pay its obligations in silver. In pre-war Russia and Austria-Hungary the Central Banks usually provided themselves with an ample supply of foreign credits to satisfy the demand for exchange purpose.

A huge supply of foreign bills was held in their portfolio ready to be melted as occasion arose.[4] Every one of these countries also pursued the one way policy with reference to gold. While they were adept at increasing their gold stock and laying on to it they never passed the policy of shutting their door to new

[1] Dr. E. E. Agger, " Organised Banking."

[2] In addition to this Imperial displeasure the Reischbank varies its rate of discount like the Bank of England to protect its reserve.

[3] H. V. Burrel, "The London Banker's Magazine," 1916, p. 210.

[4] The wisdom of holding too many foreign bills in the cash reserve of a country has often been questioned. The advantage of holding foreign bills as supplementary to the metallic reserve lies in the obtaining of needed elasticity in the reserve but these bills should not be held to a large extent. The danger is the possible suspension of the metallic standard in case of war by countries on which the paper is drawn. See Dr. F. Mlynarski, " The Central Banks " for a repetition of the same objection; also his paper before the Gold Delegation Committee.

and unwanted gold stocks. Their policy of gold nationalism was such.[1]

Such were the methods that were resorted to by the European continental countries in order to protect their national reserves and maintain larger gold reserves than those actually needed by the country. It is not the 'external drain' alone that is a great menace to the national reserve. Even the 'internal drain' which was so significant in the earlier days was not after all so very dangerous to the solvent position of the national banks.[2] A system of hearty co-operation and better understanding among the important members of the money market can effectively withstand internal pressure.[3] The internal pressure is after all due to the indiscriminate creation of credit obligations on the well-known assurance that the provision of cash ultimately falls on the Central Bank. Thus the sins

[1] See Dr. Edwin Cannan's Modern Currency. "The main obstacle to improvement," he says, "lies in the superstition and muddle-headedness on the reserve," p. 86.

[2] Mr. Montagu Norman says that the day-to-day policy of the Bank of England is guided by international considerations. The initial effects of a rise in bank rate are usually greatly exaggerated and will be more psychological than real. Weighing internal and external considerations the disadvantages to the internal position were relatively small compared with the advantage to the external position. See his Evidence before the Macmillan Committee.

[3] This is absolutely essential now-a-days because the Central Banks have powerful rivals in the big banking concerns arising out of amalgamations. Formerly the Central Banks used to control the short-term loan fund of the money market and a mere withdrawal of £2 M. cash led to a rise in the rate of discount in the L. M. market. But now things have changed. The ordinary banks possess larger resources than the Central Bank in most of the economically developed countries.

committed by the ordinary banks visit the Central Bank. In order to prevent such stringency the Central Banks always advocate a reasonable restriction of credit and exercise a salutary control over the banks at least in times of emergency. They also exercise a strong moral influence in the credit market and pursue a uniform policy as regards gold movements [1] so that unnecessary fluctuations in the value of their currencies may be eliminated.

Those Central Banks whose duty is to control the monetary standard and prevent any abnormal varitations in it have to carefully adjust their discount rate. Much depends on a wise administration of the bank rate and the intention of the needed psychological forces on the motives of the businessmen.[2]

[1] Prof. Gustav Cassel in his lecture before the Institute of Bankers (May, 1931) says that "all laws regulating the gold reserves of the C. Banks should be abolished." From the standpoint of commonsense he is right for the mistaken view that a large gold stock indicates that banking strength has to be curbed. The nervousness arising in the minds of businessmen when gold is leaving the country is entirely unwarranted by facts and figures. That much of gold which can promptly correct an adverse rate of exchange has to be kept by the C. Banks and that the remainder of the gold stock is absolutely useless should be the universal education that is needed at present.

[2] Sir J. C. Stamp says : "The raising or converting of the bank rate may sometimes be ineffective as a motive power in the machine. It is like a cog-wheel on a ratchet and as perfect in its operation, but the ratchet is short in range and when the cog passes beyond either end it ceases to function and bring the machine into action or to maintain the metaphor, conditions may be so abnormal that the load on the machine to be moved is so great that the axle loses its grip in its setting in the wheel and goes round and round uncontrolled by wheel or ratchet." Prof. M. Bonn who also realises that the screws of credit control are inefficient and useless gives concrete instances of discount policy of the Reichsbank failing to acheive their real aim. Paradoxical consequences have resulted during the years 1924-28. See his article "the German Crises," the Yale Review—Spring, 1932.

The movement of the bank rate governs the movements in the other money rates of the market. Just as the discount rate aims to prevent the variations in the general price-level and the monetary standard so also the true rate of interest for the bank loans should aim at the self-same ideal of tolerable price stability, stable rates of interest, the checking of trade fluctuations, the stabilising of employment and production activity by meeting their lawful credit demand and the checking of unnecessary gold movements. The philosophy of Central Bank control policy is thus a peculiar amalgam of sometimes divergent and mutually contradictory aims and an introduction of order and a systematic plan into the conflicting aims of the competitive modern profit-seeking capitalistic society is the main endeavour of the modern Central Banks.

If these fundamental objectives are not remembered and the banking institutions are allowed to indiscriminately create credit, bearing in mind their own immediate cash holdings, the rational direction of social production would be sacrificed. Suppose there is a great demand for capital arising as a result of the discovery of new progress or the opening up of fresh market in new countries, the banks should raise the rate of interest and check the use of capital in those purposes for which it was being used under normal conditions. The less urgent demands would be curtailed and incentive given to the savers of capital to

increase their supply.[1] This is the double duty which the banks ought to perform. If there is no change in the rate of interest necessarily the banks have failed to perform their duty. As Prof. Gustav Cassel says, " if this splendid instrument, the rate of interest is not properly used, the whole production of the community may be directed to future ends to a much greater extent than it would really desire. Under such circumstances the supply of present goods cannot be made to meet the demand, unless something artificial is done to restrain this demand that is, unless a general rise in the prices of commodities takes place. It is probable that the rise of prices will prevent those uses of capital which would otherwise and more properly have been prevented by a rise in the rate of interest. Thus a community which may be quoting a lower rate of interest than the market for the use of capital really requires would deceive itself and the

[1] Prof. Keynes expresses this fundamental truth in an eloquent manner in his new book, the " Treatise of Money." The banker is an intermediary attempting to equate the supply and demand for capital. ' The equalising of savings and investments ' is the bounden duty of the banking system (p. 279, Vol. II). Investment booms arise if the banks fail to check undue demand by raising the rate of interest and pursue the policy of " easy and cheap money." Investment slump may arise as a result of bank deflation. If the credit fluctuations do not sympathetically conform themselves to trade and economic disturbances the banking system has failed to be of any use. Intelligent credit control must not make the appearance of credit cycle, or stock market boom, or widespread unemployment or excessive variations in business productivity or any convulsive movements of world economic life any longer possible.

national direction of social production would invariably suffer from such a false policy."[1]

In the section on loans and advances it has been related how the loan policy of the commercial banks is always guided by the proportion of reserve they keep against their outstanding liabilities. The regulation of currency in advanced countries lies in their hands as the cheque currency they create forms the greatest portion of the money stock required for business transactions in the country. Even in the most civilised countries of the world there are seasonal movements requiring additional currency at some particular periods. The commercial banks, so long as they are aided by a central bank on such occasions, are the best media in providing the huge volume of currency needed on these occasions. While the cheque currency is admirably endowed with expansive ability, yet it seems to lack the required automatic contraction, with the result that the price-level remains the same and, although the social demand for currency has lessened, the supply of currency remains the same. The policy of regulating the loans with reference to the reserve should be coupled with the policy of looking to the social needs of the community for currency; unless this ideal is pursued the cheque currency would not decrease if the banks merely issue loans with sole reference to their cash reserve alone.

Again the social and productive needs of the community require that the banks should always pursue

1 *Vide* Gustav Cassel, "The Nature and Necessity of Interest" pp. 167-69.

a strict policy tightening the control over the loans they made so that a period of business over-confidence and expectations of rising prosperity may not culminate in a crisis. The sole duty of the banker is to check any uneven development. This ability arises by virtue of his very wide and general information about finance, production, marketing, consumption and other aspects of economic life. As Veblen says, " the banker belongs to the class of pecuniary experts whose business is the strategic management of interstatal business relations of the economic system." This they can do, as Prof Fisher says, by not maintaining mere nominal rates of charges for the accommodation they grant to the business. Suppose prices rise for some reason or other. Then the businessmen would be tempted to borrow and the banker ought to realise that the rate of interest which he has been maintaining in times of stationary prices should rise in order to maintain the same old relations between the debtor and the creditor. To quote Prof. Fisher's example if prices are rising 3% a year and if the rate of interest in the stationary period of prices is 5%, the rate should rise to 8·15 per cent. a year, but generally it does not reach sufficiently high. It may rise to 6 or 7 per cent. This tardiness of adjustment keeps down the market rate of interest far below the natural rate of interest. Similarly when prices are falling the rate of interest does not drop down in conformity with falling prices.

The inability of the banker to promptly adjust the rate to the real circumstances of the social and

productive needs of the community tempts the entrepreneurs to borrow further. Deposit currency expands with the bank loans and prices continue to rise. As Prof. Fisher says, " rise of prices generates rise of prices and continues to do so, as long as the interest rate lags behind its normal figure." Unfortunately this expansion cannot be continued for ever. The banks, as soon as they reach the limit that guides their loaning policy, *i. e.*, as soon as the pressure on the cash reserve is felt, raise the interest rate as a measure of pure self-defence. With the rise in the rate of interest the value of securities falls and they cannot be used as collateral for securing further bank loans. This tends to check the loans made by the banks. The entrepreneurs who fail to get their bank loans renewed expect a business failure. These by their failure involve the banks who have lent to them. The depositors make a ' run ' for their cash and the bank reserve falls to a low figure and the banks are unable to make any further loans just at the time when the entrepreneurs would be willing to offer high interest rates for any accommodation they may be afforded. With the refusal of the banks to loan, their bankruptcy becomes a settled fact and a crisis is the culmination of an upward swing in prices. All this has arisen by a " belated adjustment of the bank charges." This is the monetary cause of crises and it solely lies in the maladjustment in the rate of interest and disturbances in the price-level arising out of imperfect banking and currency management.

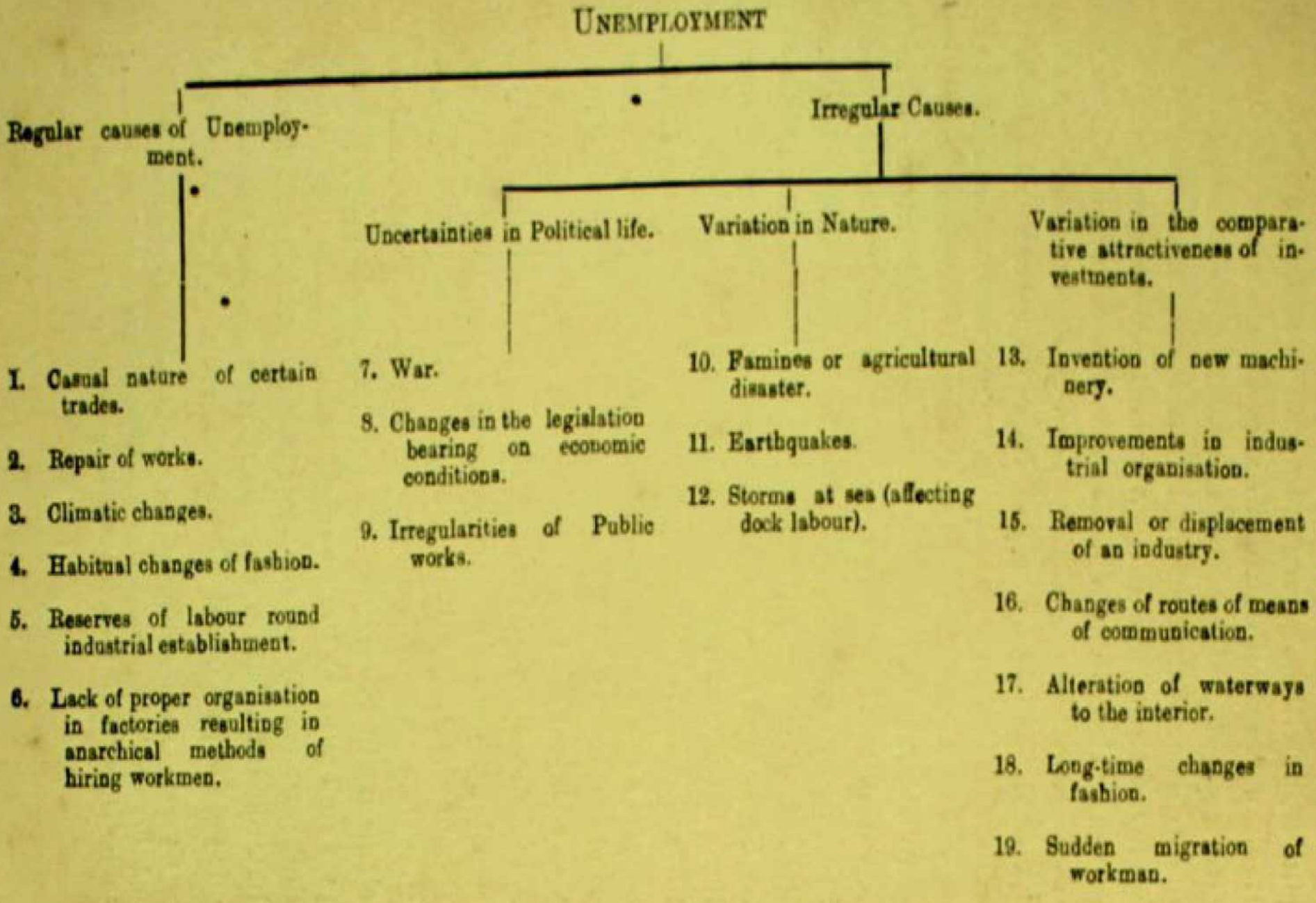
Even overinvestment and underconsumption which may be considered as some prominent causes for crises are really monetary in nature. So far as this monetary school says that "banks should be carefully adjusting the rates of interest for short-loans paying much attention to the social needs of the community," it serves a useful purpose. If it is carried to extremes it is doubtful if there would be any utility of this doctrine. R. G. Hawtrey says, "unemployment is due to a defect of organisation, a maladjustment of the monetary machine or a paralysing influence of credit contraction." According to him, "the volume of trade borrowing is amenable to human control. The Central Bank exercises this control by its discount rate and it can correct the effect of all others." He attributes the present unemployment situation of England (1921) to the deflationary policy on the part of the English Joint-Stock Banks. Says he, "It is quite superfluous to seek for other causes of depression and unemployment when there has been so tremendous a deflation as to reduce prices by half in less than two years" (Post-war era).

Mr. Hawtrey ignores the fact that the post-war situation [1] was entirely due to world conditions and his remedy to lower the English Bank rate as a corrective to the domestic situation could not have accomplished much indeed. "Trade," as Hartley Withers

[1] Professor Lionel Edie puts this idea in a clear manner when he says, "The curves of credit growth and production growth should run parallel with each other. More than this is too much and less than this is too little." See his "Banks and Prosperity," p. 117.

puts it, " will not continue on an even keel even if the Bank of England makes an appropriate use of its bank rate weapon. Unemployment cannot be considered as purely a credit phenemenon and by controlling the credit situation the unemployment problem will not be solved. Unemployment is often the resultant feature of a concetenation of economic, industrial and political causes."[1] To hope to correct all these extraneous causes outside the monetary field is to expect to achieve the impossible. As Conant rightly emphasises, " money is not the unique cause of all economic changes " but none the less " disturbances in the currency system play an important part in industrial economy." Several of the contemporary economic problems would appear in an entirely new light if the characteristic part that money plays is fully understood. It is the bounden duty of the banks to study them in this light and realise the true social needs and productive requirements of the community. They should lend just enough and no more than the actual money work that has to be performed in a society. A rise in the general level of confidence should not carry them away. The cheque currency that they create together with the other heterogeneous elements in the money stock of the community should just suffice to do the money's work. It is only when the purchasing power consisting of the different heterogeneous units like bank notes, gold coins, and cheques is just equal to the money's work, that the

[1] In the second edition of his book, " Gold Standard in Theory and Practice," he admits this truth and says that " outbreaks of unemployment occur from multifarious causes in particular industries."


UNEMPLOYMENT
Regular causes of Unemployment.
Irregular Causes.
Uncertainties in Political life.
Variation in Nature.
Variation in the comparative attractiveness of investments.
1. Casual nature of certain trades.
2. Repair of works.
3. Climatic changes.
4. Habitual changes of fashion.
5. Reserves of labour round industrial establishment.
6. Lack of proper organisation in factories resulting in anarchical methods of hiring workmen.
7. War.
8. Changes in the legislation bearing on economic conditions.
9. Irregularities of Public works.
10. Famines or agricultural disaster.
11. Earthquakes.
12. Storms at sea (affecting dock labour).
13. Invention of new machinery.
14. Improvements in industrial organisation.
15. Removal or displacement of an industry.
16. Changes of routes of means of communication.
17. Alteration of waterways to the interior.
18. Long-time changes in fashion.
19. Sudden migration of workman.

20. Involuntary changes in factories

21. Changes in monetary volume or price fluctuations.

22. Abuse of competition and speculation.

23. Sweating system and abuse of employment of women and children.

24. Excessive prolongation of the hours of labour.

25. A crisis abroad or a change in the market of some other country.

26. Changes in foreign competition and production.

banks are maintaining an equilibrium position without disturbing the general price-level. Neither less nor more than the actual requirements ought to be created by them. This is the chief reason why the banks ought to regulate their loans not merely by virtue of their cash position or reserve holding but by the true social productive needs and requirements of the community. It is too much to expect that the purchasing power of the monetary unit can be completely stabilised at a particular level by the mere will and discretion of the banker.[1] The banker supplies only a part, perhaps a major part, of the total volume of money at the disposal of the society. Hence his power to control credit and through credit the variation of the purchasing power of the monetary unit is proportionally limited. [2] But that is no reason why it should not be exercised in the best interests of the community.

The banks should only remember what Dr. Marshall said long ago, " it is worth while to do much

[1] Governor Benjamin Strong puts the self-same idea in the following language : " Price changes must form out of a combination of many influences. So far as the influence of credit is a factor in prices I am frank to say that I think our policy should be to avoid any development which would promote or encourage simply price expansion or price contraction. We should aim to keep the credit volume equal to the country's needs and not in excess of its needs and the price readjustments as between the various classes of commodities will take place with the least possible disturbance."

See " Interpretations of F. R. Policy," by Benjamin Strong, p. 211.

[2] The four main reasons why credit control policy cannot be effectively exercised are the following :—The maintenance of a reserve and the stabilisation of price level are two principles that are largely incompatible. The price level is more or less an international issue and without international policy nothing can be done. No banking system can hope to control the insidious influences which go to make up the adoption of a "policy of inflation." It might also happen that the requirements of Government might run in the opposite direction to that needed by the credit control policy. See. Dr. W. E. Spahr, " The F. R. System and the Control of Credit."

in order to diminish the variations in the value of the monetary unit a little." The correct anticipation of the future trend of the variations in the monetary unit can best be done by an association of bankers which should fix a common policy and the minimum rates at which the loans can be granted by the individual banks.[1] Collective action is required to secure the social interests. As Lavington says, "a deliberate regulation of the supply of bank money in a centralised banking system is not to be considered as a unique economic phenomenon. It is only an application to a specially important case of the general rule that fluctuations in the value of individual commodities are productive of social disturbances and that some of the causes of these disturbances may be eliminated by unified action to the general social advantage."[2]

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[1] Hartley Withers, "Meaning of Money," chapter on the Bank Rate and the Market Rate.

[2] F. A Lavington, "The Capital Market," p. 62.

# CHAPTER VI

## How Profits arise and are Distributed

Having studied the profitable and non-profitable assets of the commercial banks it remains to consider how profits arise and how they are distributed.

A sum equivalent to the capital of the bank and the " reserve fund " if any is generally invested in gilt-edged securities. Too large a holding of one kind of investment is never made by the banks. Different kinds of widely saleable securities are held by them. Formerly the Indian joint-stock banks used to invest in 3½ per cent. Government paper to a great extent. But now War Loans yielding 5 to 6 per cent. are held to a great extent and the Treasury bills also secure a good round sum of 6 per cent. interest.

Interest has to be paid on fixed deposits. In order to induce people addicted to the hoarding habit a sufficiently high and tempting rate is to be offered. The rate itself depends on the time for which the deposits run. Four to five per cent. is the average rate for 6 to 12 months in the Indian money markets but one special feature is the nature of fluctuations of demand in the market. They evidence a keen desire to have deposits to help them during the busy season which falls in the first and last quarters of the year but during the slack season there is no demand for their money and hence there is no anxiety on the part of the banks to attract deposits in the slack season. The banks have

to utilise these funds at a higher rate in order to secure profits. The ordinary opinion on bank profits is that it is the margin between the rate the bank allows for deposits and the "street rate" for bills. This conception is crude. The banks obtain "current accounts" for which they pay nothing. The Indian banks are an exception to this rule. It is the current accounts that furnish the largest amount of the banks' working capital and this money is used in discounts and loans fetching 4 to 6 per cent. rate. It is mainly against these liabilities that the banks have to maintain a proper cash reserve. It is these that test the efficiency and the adequacy of the cash reserve. The banker always sees that the cost of the work done in connection with this service does not rise higher than the net rate of interest he obtains by using the customer's deposit. Instead of examining each account in this manner the banks generally impose a half-yearly commission charge for the services to be performed in connection with the current accounts.

The banks lend their credit and it is out of this that they get the largest return for they have to pay nothing for this. They have to guard against an improper use of credit and should be always anxious to maintain the integrity, good name and good-will of the banks by promptly meeting all their obligations. The banks can extend their credit in the shape of discounts, loans and acceptances and these bring them variable returns. Loans generally fetch 1 per cent. higher rate of return (known as interest), *i.e.*, 3 to 4

per cent. The difference between discount and interest is mainly this. The discount is a charge deducted from the customer's bill in advance ; while interest is paid at the termination of the loan. Acceptances fetch about ½ per cent. They have to maintain an adequate reserve against all their liabilities.

The use of dormant or unclaimed balances is also profitable business for the banks.[1] The management of trustee business for the trust property, if undertaken, is also a lucrative one.[2] The banks secure commission for the supply of letters of credit [3] to their travelling customers and for other numerous services they may elect to perform for them.[4]

The gross profits or current earnings of the banks consist of minute driblets of discount, interest and commission charges accruing daily on many thousands of transactions. The volume of the profits is mainly dependent on the rapidity of turnover of their business.

The banks derive the net profits by deducting their expenditure charges, interest on fixed deposits and

[1] An attempt was made to confiscate the ' dormant balances ' in the hands of the London banks during the period of the late War. A committee was appointed but it reported against confiscation.

[2] The usually recognised functions of a Trustee are to act as an executor, administrator, or trustee for mortgage in the case of real estate, act as registrar and transfer agent for stock, assignee, receiver, guardian and curator.

[3] In this connection the "World Letter of Credit" of the Lloyd's Bank should be mentioned. It has established 5,000 agencies in the commercial world and money can be obtained easily at all these places.

[4] The commercial banks generally perform a variety of minor services such as the purchase and sale of securities, through their brokers, the safe custody of valuables, the collection of coupons and short bills of exchange and the issue of drafts.

current accounts (if paid) director's and auditor's fee, contributions to pension or provident fund, income or other taxes. It has to pay subscription to Chambers of Commerce, etc., printing, postage, advertising, and stationery charges, travelling charges and provision for depreciation of investments and building is also made and deducted annually out of the gross profits. Bad losses arising out of bankruptcy of customers or frauds perpetrated on the unwary banker or defalcation made by bank clerks due to insufficient and negligent supervision on the part of bank inspectors or an improper use made by bank officials of the banks' money have to be wiped off " clean " and the remainder alone has to be paid to the shareholders. If bad losses do not arise decent provision for a reserve fund has to be made. Sometimes provision out of current earnings has also to be made for writing down losses on investments.

The net profits of a bank depend on the capable management by its officers. Loans to tried and approved customers on first class securities and adequate provision for their depreciation should be made by keeping a handsome margin in its favour. Good directors, active and energetic clerks, and capable auditors can make the banking wheel rotate without a flaw or hitch and the greater the revolutions it makes,

[1] The practical benefit of this custom lies in the possibility of writing in again if the securities have appreciated in value. Were the special reserve for the purpose of depreciation of investments to be kept apart and no longer required for that purpose it can be used as an additional provision for bad debts. Thus it can act as a second line of defence against loss.

without any jerks, the greater is the profit. A thorough over-hauling of work by expert accountants at irregular and uncertain periods will stop any loopholes to the bank clerks for defalcations.

If in spite of all these precautions bad debts are still contracted or if certain assets fail to materialise they should be written off and the reserve fund is to be utilised in the case of any such unforeseen calamities. The concealing of liabilities has to be vehemently condemned and the attempt to whitewash the wrong-doings of dishonest officials is not at all a laudable feature. It is a more heinous crime than the one of "window-dressing" its balance-sheet.

Bank dividends are calculated on the paid-up capital and never on the capital and the reserve fund put together. It is always in the interests of the banks to increase their reserve fund after maintaining a steady rate of return to the shareholders. Dividend ought to arise out of the existence of profits alone. In no instance should it be paid out of capital or the assets obtained by a use of the paid-up capital of the bank. A fluctuating dividend eads to speculation in the value of the bank shares and the good name of the bank may fall into disrepute by a low quotation of its share value on the stock exchange.[1] A safe and steady dividend on the other

[1] Bank shares can be considered as safe, lucrative and steady items of investments only when they are managed soundly, economically and efficiently and steady profits are declared annually.

One noticeable feature of late is the possibility of extending banking services in other directions with the necessary result that banks in spite of trade depression can count on steady profits and dividends.

hand confers a sort of a *quasi*-consol-like air to the bank shares. A fluctuating dividend is often indicative of poor management.

It is often stated that banks are able to declare very high dividends as they have a virtual 'monopoly' of money. Nothing is further from the truth. Banks have several competitors such as insurance companies, and building societies. Just as banks attract savings these also attract savings and compete with the bank in the matter of lending. There are other lenders who would undercut the bank's rates if they are high. Hence the banks have always to realise the force of this competition and accordingly render services at any possible or paying rate.

# CHAPTER VII

## Relations between Several Banks.

The several points of contact—*Sec. I.*—Definition of clearing house—the principle of clearing and its advantages—credit and money—The substitution of credit for money—The mistaken view that money can be dispensed with—Modern barter—London Clearing House operations—European Continent—Increased cheque habit in India—The American Clearing House—Are Clearing House returns economic barometers, if so how ?—The adoption of the clearing principle in other walks of human activity.

*Sec. II.*—The Central Bank—Its general features—Modern ideal of C.B. philosophy—Points of contact—Means and methods of achieving its ideal—The *modus operandi* of the C. B. control policy—Stable bank rate ideal—Ordinary routine open market operations—not competitive in nature but really a help to effective credit control—Absolute reliance on C. B.'s help as leading to injudicious banking—impossibility of checking credit inflation—wisdom of individual banks even during normal times—better cooperation between member banks and C. Banks—Banks as nobler instruments than mere dividend-paying machines—Social leaders—Future possibilities.

*Sec. III.—The International Bank of Settlements* :—

Its origin and expected advantages—Some of the earlier proposals—Reason for starting the present bank—The organisation of the Bank—Details of its working—Its achievements—Its future—Its definite goal—Select references.

## The Several Points of Contact.

Thus far the commercial bank has been studied in its individual isolation but during the course of its routine business a commercial bank comes into contact with other banks doing the same nature of business.

Banks usually maintain balances with other banks which are known as its correspondents. As stated already the object of these balances is to enable the depositing bank to sell drafts and issue letters of credit against it. The correspondent bank purchases commercial paper, say bank acceptances, or grant call loans on behalf of the depositing bank. This relationship also enables them to secure trustworthy credit information originally collected by the correspondent bank. It also facilitates the clearing business and the collecting of cheques and credit instruments can be done by the correspondent bank. The depositing bank can secure aid from the correspondents by selling its investments or discounts. In the latter case it acts as the collecting agent of the correspondent bank which buys them.

It has been mentioned that the loan of one bank may become the deposit of another bank. As a matter of fact, the loaning capacity of one bank depends on the action of the co-lending banks.

In the chapter on deposits and discounts it has been explained how the rights that are created by the several banks are crossed against each other and settled in a Clearing House account.

In the chapter on Cash Reserve it has been hinted that under a highly organised banking system where mutual co-operation between the several banks is the rule, a smaller cash reserve may safely be kept by the individual banks. While studying the reserve of the banking system as a whole the credit-controlling power of the Central Banks with a view to preserve the national gold reserve has been mentioned.

## Section I.

### Clearing House.

A Clearing House has been described as " one of the wonders of the world." [1] The stupendous number of cheques and bills that pass through several hands of the 'clearing banks' technically known as " charges," the easy way in which the claims of one are offset against each other, the making of actual payments at the end of these transactions by mere transfers in bank ledgers, the minimising of labour, the economy of cash and the saving of time[2] are indeed wonderful things.

The principle of its working is nothing different from that of an ordinary bank. The entire banking business is primarily based on the complex system of contra-accounting, *i.e.*, the putting of figures to the debit and credit side of the books of the bank. The bank by means of such adjustments in this book enables two individuals to pay their mutual obligations without the intervention of cash. A owes money to B. A draws a cheque on the bank and B the payee deposits the cheque in his favour. The bank

[1] H. G. Moulton, " Money and Banking, " p. 94.

[2] Cannon says, " The speed with which the business of a Clearing House is transacted seems quite incredible. The actual time required to make the exchanges varies from one and one-half minutes to two minutes. The time varies in proportion to the number of members.

The clearances in the New York Clearing House exceed on the average £ 300,000,000 and yet this enormous amount of paper is exchanged between the banks in ten minutes and often in less time."

debits A and credits B with the amount. Just the same thing is done by the Clearing House mechanism for its clearing banks. In return it receives all bills and cheques it has to pay and then strikes a balance. If it has to pay it draws a cheque on its account at the banker's bank which is utilised for making such payments in favour of its creditor banks. This cheque is credited to the Clearing House account by the banker's bank. The creditor banks get their account from the Clearing House account and their account at the banker's bank is credited with the amount. Thus not a single coin need pass through the hands of these bankers, yet their mutual indebtedness is cancelled. The precious metal lies securely warehoused and guarded in the bank's reserve. The metallic reserve of the bank does not act as a medium of exchange. It serves only as a guarantee fund insuring the capacity of the bank to fulfil its obligations when called upon to pay a balance. Money is fulfilling just the same function it did on its first invention. The original function of money was to act as a treasure. Only occasionally it was used as a medium of exchange.[1] It plays the same part in the modern credit system. Acting to a great extent as a treasure it acts as a medium of exchange now and then. The evolutional development of the Clearing House clearly separates the functions of credit and money. To money is

[1] G. W. L. Taylor says, "Credit documents have been elaborated into the common medium of exchange while gold retains its original quality that which imparted to it the primitive provisional attribute of circulation, namely, the storing of value."—The Credit System, p. 294.

allotted the task of serving as a store of value and the task of exchanging is thrown on the shoulders of credit.

Credit and money perform complementary services. The guarantee and standard functions belong to money, that of exchange to credit. But this distinction becomes blurred during the period of a crisis. In this troubled period all the functions are relegated to metallic money and possibility of peaceful substitution of credit for money has to be abandoned.

Theoretically speaking under sound banking conditions aided by an efficient clearing mechanism credit is capable of indefinite expansion. The substitution of credit for money can take place to a remarkable degree but that depends on the ability and experience with which the bankers judge their borrowers. Several of the economists who realise the infinite possibilities underlying the creation of credit have gone to the extreme length of declaring that "in a perfected society where human nature is less liable to errors of judgment" money can be literally dispensed with. MacLeod speaking of the clearing house principle says the whole system can go on for an indefinite length of time without a single coin being required. The wider the net that the banks spread and the greater the number of people that are included within this net, the more possible is it to equate all payments in and out of the bank. J. S. Mill dreams of the possibility of the whole nation keeping accounts with one bank only and "in this ideal case there would be no money anywhere but in the hands of the bankers who might then safely part with all of it by selling it

as bullion or lending it to be sent out of the country in exchange for goods or foreign securities. But though there would be no money in possession or ultimately perhaps even in existence money would be offered and commodities bought with it just as at present. People would continue to reckon their incomes and their capital in money and to make orders for the receipt of a thing which would literally have ceased to exist."

J. S. Mill has apparently fallen into the same groove of thought as MacLeod. It is unwise to think of cash and credit operating in different fields unconnected with each other. "The important truth of their unity of essence, constant interaction and at the same time specialisation of function" should not be forgotten. Credit would be first useful as an economic supplement to metallic money till a widespread organisation of it ensues and metallic money actually becomes relatively subordinate to credit. Metallic reserves cannot be totally dispensed with. Although the principle of "set-off" in place of actual money or cash payments can be utilised in an extensive manner still the laying down of cash is necessary in matters of retail trade and payment of wages. The banks have to guard themselves against this possible contingency of the depositors demanding "hard" cash. Some of them might not feel satisfied until they obtain metallic money.

The three important steps in the clearing process are (1) the acceptance of bills and cheques by those upon whom they are drawn ; (2) a comparison of accounts—the reciprocal claims are "cleared' by being set off

against each other—and (3) payment of uncancelled balances by mere book entries.

W. S. Jevons, who was one of the first economists to observe the beautiful simplicity of procedure and the immense results flowing out of it, describes it as a "return to barter." Really speaking the clearing principle is nothing but a species of highly concentrated representative barter.

As Lord Farrer says, "money has become merely the measure and language, not the actual medium of exchange and the development of modern credit operations had led to a return to barter." [1] The Clearing House is nothing but a big bartering house. As the German Economist, Hildebrand, in his enthusiastic belief of a "constantly unfolding evolution" in our society prophesied [2] the money economy has given place to credit economy and the most conclusive proof of this transition is the development of the Clearing House which economises the use of m oney to the

1 Lord Farrer, "Studies in Currency," p. 84.

2 Recardo himself prophesied this tendency so long ago as 1816 in his pamphlet "proposals for the establishment of an economical and secure currency." While pleading for the development of the gold exchange standard system he wrote as follows : "The introduction of the precious metals for the purposes of money may with truth be considered as one of the most important steps towards the improvement of commerce and the arts of civilised life but it is not less true that with the advancement of knowledge and science we discover that it would be another improvement to banish them again from the employment to which during a less enlightened period they had been so advantageously applied."—Recardo's works edited by McCulloch, p. 404.

greatest possible extent chiefly by the development of credit instruments. [1]

In London, the Clearing House operations reach gigantic proportions. There are ten provincial Clearing houses at the various trading centres of England. In 1913-14 the cheques actually stamped amounted to £312,000,000, in 1917-18 they amounted to £324,000,000, in 1919-20 they reached the figure of £360,000,000. [2] Roughly one million cheques are drawn each working day. The aggregate value of the cheques cleared in 1912-20 amounted to m. £39,000 As Giffen says, "a large number of cheques do not pass through the clearing house" and he estimates that these would on the aggregate amount to £50.[3]

On the European Continent the Clearing Houses have been started very late [4] and are relatively unimportant on account of the fact that the cheque system is not much in evidence. The Central Banks adopt the "giro transfer system," which obviates the

1 Speaking of the metamorphosis of the Clearing House one economist says, "it is something analogous to the changes of function that often characterise the evolution of species in the lower world. The transformation of the swim bladder into the lung is hardly more remarkable than the development out of this Clearing House device of a governing body called to take the helm in times of danger." —W. Carlisle, "Monetary Economics," p. 128.

2 The London Times, May 20, 1920.

3 Sir R. Giffen, "Statistics," p. 315.

4 The Vienna and Paris Clearing Houses were instituted in 1872. The Berlin Clearing House was opened in 1883 and the St. Petersburg C. H. in 1893. A good idea of the C. H. mechanism of different countries can be obtained from J. G. Cannon, "Clearing Houses."

necessity to resort to the Clearing Houses. In the case of the Reichsbank it acts as the clearing bank for all the important banks in Germany. Through its 480 branches it receives payments to be placed to the credit of other banks with the Reichsbank. It opens accounts for private firms or persons and money can be sent by them all over Germany through the intermediary, if necessary, of the accounts which other banks keep open with the Reichsbank.[1] The use of postal cheques in Austria, Germany and Switzerland also furnishes a cheap internal form of remittance so that bank cheques are not much in evidence there. Attempts are being made in these countries to develop this efficient method of this cheque currency. The cheque law of 1908 has been enacted in Germany with a view to remove all obstacles against the actual circulation of the cheques.[2]

During the recent war France, Germany and Switzerland [3] also made special efforts to induce people to resort to cheque payments.

The increased popularity of the cheque habit in India can be seen by the increase in the number of Clearing Houses and the large number of cheques

1 "Currencies after the War"—'League of Nations' publication, p. 52.

2 The 'Grossbanken' by Dr. Reisser, pp. 147 and 217. Also see the miscellaneous articles on German banking: 'The Giro System" and the Use of Cheques in Germany.

3 In Switzerland even after the war, the Post Office stamped generally on all letters the legend that "payment by cheques save notes and coin." See G. Cassel, Money and Foreign Exchanges after 1914, p. 32.

which are being cleared therein.[1] Owing to the imperfect development of banking or the credit system the proportion of bank money to coin used in India is very little.

The American Clearing House is the most progressive one of all these institutions. It not only does this " clearing " of cheques but it functions in the following manner. It facilitates the handling of business between its members. It facilitates business with member banks, trust companies, and banks of other localities. It fosters and encourages conservative, safe and sound methods of banking practice. It exercises its influence in matters of common interest to its members and for the general good of the community. It performs such other services imposed on it by the member banks. It arranges for the granting of a loan to the American Government by a *pro-rata* allotment. It controls the advertisement policy of the banks. It fixes minimum rates of interest for deposits, uniform rates of exchange and charges of collection. It issues Clearing House loan certificates to mitigate financial panics.[2] No wonder, due to the absence of a Central Bank the American National Banking system had to depend on these Clearing Houses for advice, regulation and

[1] A study of the financial proceedings of the All-India Government reminds one of the attempt made to reimpose the one anna stamp duty on the cheque. Fortunately for the country the Indian Legislative Assembly has vetoed this proposal for the reimposition of one anna stamp duty on the cheque (April, 1933).

[2] A similar use of Clearing House loan certificates was resorted to in the London Money Market during the late war.

help in all such emergencies as commercial crises. The American Clearing House stands as an example of ideal mutual good-will, mutual control and mutual help that can be developed in a decentralised system of banking with thousands of small banks scattered all over the country.

This progressive policy of the American Clearing House was not altogether barren of noteworthy results. The vigilance of their examinations [1] rectified the bad and incompetent management of several banks. It has created a feeling of friendly co-operation eradicating the tendencies of mutual rivalry and jealousy resulting out of unhealthy competition. A high banking standard has been set up as an ideal before all the member banks. All culprits who secure

[1] Cannon says," Special bank examiners assisted by trained experts are employed by the Clearing House to supplement the work of the Federal and State Bank's examiners. The Chicago Clearing House developed this idea first in 1906"—" Clearing Houses," p. 25. See also Proceedings of the American Banker's Association, 1910, pp. 689 and 690. Mr. J. B. Forgan says, " Our methods insure the stirring up and elimination of the sediment which is liable to accumulate in the banks. I am in the habit of classifying bank assets in dairy terms such as cream, sweet milk, skim milk, sour milk and sediment. In the bank, as in the dairy, the sediment falls to the bottom where it remains out of sight and out of mind unless certain vigilance is exercised in its elimination. If a bank's management is weak the cream is liable to be stemmed off the top, while the sediment accumulates at the bottom and gradually its assets become so permeated with it that they form a putrid mass of curds only fit for the dump pile of a receivership. Clearing House examinations tend to the healthful conservation of the sweet milk and cream and to the elimination of the sour milk and sediment." Again " it attempts to check excessive multiple borrowing " by a system of co-operation amongst the different bank examiners.

too much banking accommodation can be easily detected by the examiners of the Clearing House. The newly created Federal Reserve banking system has introduced efficient methods for collecting and clearing cheques. Just as one National Bank "clears" for its depositors, so the city Clearing House "clears" for its banks, the Federal Reserve Banks for the banks of its district and the Gold Settlement Fund at New York for the Federal Reserve Banks of the entire country. The first is done by the bank clerks, the second by messengers to the Clearing House, the third by mails and the fourth by the telegraph. As one banker remarks "this progress in banking business follows the order of human progress and invention."

Very often the Clearing House returns are spoken of as economic barometers indicating improved business activity. But a good deal of caution has to be employed while interpreting these figures. Variations in price levels may change clearings without altering the value of business. Again changes in business practices or banking conditions would reduce the use of cheques. The proportion of inter-bank cheques to the total cheques may not be the same. Banks are not uniformly distributed all over the country. Cities with big banks will conduct a given volume of business with a smaller volume of clearings.

But a wise recognition of the advantages of the "Clearing Principle" has led to its adoption in the matter of settling stock exchange operations and the Railways have always adopted this principle. It is

also noticeable in the settlement of transactions of such goods as sugar and cotton in the United Kingdom. These Clearing Houses attempt to economise the use of bank money. It is also noticeable in the settlement of transactions of such goods as sugar and cotton in the United Kingdom. It is proposed to hold an "international clearance fund." Clearings between these financial centres might be performed by the wireless message.[1]

## Section II.

### Relations with the Central Bank.

### The Central Bank.

In every banking system there is one institution whose recognised function is to make the financial system run on an even keel and this is rightly designated as the Central Bank of the country.[2] It has the power and it also recognises it as its duty to control the volume of credit and currency

[1] This necessity has almost been eliminated by the starting of the Bank of International Settlements. Almost all important Central Banks can deposit balances with this super-Central Bank. Rationalisation in the matter of gold movements would naturally arise out of its activity. The economising of the use of gold is one substantial advantage arising out of its successful working. "The stabilisation of world prices" may or may not be attained. But the B. of I.S. is bound to have a beneficial influence on the course of international finance and the gold monetary standard. Its potentialities as well as dangers can be realised by referring to the section on B. of I.S.

[2] For a proper understanding of the constitution, duties and operations of a Central Bank of Issue, see my Present-Day Banking in India, Chapter III.

in circulation besides acting as the ultimate depository of gold. While performing this duty it admirably fits itself into the gold standard monetary organisation by regulating the gold movements, *i.e.*, the ebb and flow of gold from and into the country. The duty of preserving the gold standard from the influx or efflux of gold is the bounden duty of the Central Bank. It is the performance of these twofold duties of checking the effects of disequilibria and the restoration of equilibrium that enables any institution to be designated a Central Bank.

### Its General Features.

So far as its general features are concerned it is the depository of part of the reserves of the other banks. It is the banker's bank in whose hands the national gold stock, *i.e.*, the entire basis of the credit structure and the sole basis of the one reserve system is kept for the purpose of pursuing a strong and effective supervisory monetary policy. The Central Bank is the Government Bank accepting its deposits, managing the public debt, making disbursements on behalf of the Government and lending money to the Government within limits laid down by the legislation of the country. The regulation of the value of gold is left to it and by its purchase and sale of gold at a fixed price it tends to stabilise the value of gold at that price. The combined result of these important operations is to augment the earning power of the Central Bank and have some prestige attached to it in the money market on account of its close relations with

the Government. The Clearing Banker's Account is also maintained with the Central Bank. Thus the Central Bank is "a great note-issuing institution in which is vested to an extraordinary degree the financial responsibility of a nation in that its methods enable it to supply at all times an elastic currency varying automatically with the needs of the country to maintain an adequate gold supply through its regulation of foreign exchange and to conserve and protect the country's metallic reserves, to control the money market by regulating the discount rate and to serve as a sanctuary for the banks in periods of threatened danger." Its aim is solely to prevent "financial disturbances, currency famines and business reversals"[1]

## Modern Credit Control.

While the older ideal of Central Bank philosophy gathered round the conception of mere monetary regulation of the gold reserves, currency and credit the modern enthusiasts of Central Bank credit propose "to achieve the stabilisation of price levels, the smoothing out of the business cycle, the relief of agriculture, the remedying of unemployment, the maintenance of business confidence and the timely restriction of speculation."[2] These onerous duties are being thrust on the shoulders of the Central Bank's executives merely because independent and unco-ordinated action of

[1] R. M. Ireton, "Central Bank."

[2] For an idea of the new C. Bank philosophy see my book, Banks and the Money Market, pp. 74-103.

the commercial banks disables them to perform these functions. Neither have these commercial banks the commanding influence power and ability. In the discharge of this tremendous trust it comes into conflict with the ordinary commercial banks.

## Points of Contact between the Central Bank and the Ordinary Banks.

In addition to the performance of clearing business for the commercial banks the Central Bank comes into close contact with the members of the money market in various ways. Besides keeping the deposits of the member banks for which no deposit rate of interest is paid the Central Banks aim at establishing an intimate relationship between the Central Bank rate and the market rate, *i.e.*, the rates of the commercial banks. In times of stringency the ordinary bankers rely on the Central Bank for cash. The Central Bank does invaluable service to the ordinary banks by extending the privilege of rediscounting to all sound banks whenever they are pressed for money.

During times of panic the Central Bank is the only purveyor of credit and the ordinary commercial banks look to this sheet-anchor of credit in all emergencies, ordinary or extraordinary. The ordinary commercial banks look upon the Central Bank as their "guide, friend and philosopher." The Central Bank can be safely compared to the proverbial shepherd guiding his flock. The very soundness of the banking structure depends on the harmonious relations between the Central

Bank and the other banks. The solidarity of the whole banking framework is a result of the ease with which the ordinary banks move round this pivotal point in the money market. The very stimulating example of the Central Bank which places before itself no other ideal than that of serving national requirements, [1] acts beneficially on the ordinary commercial banks which realise something of that ideal and try to emulate the noble example of their worthy leader. Thus viewed the Central Bank is an essential part of a well-ordered banking system without which the safety of the financial system cannot be guaranteed nor can the economic welfare of the country be assured.

## General and Special Mechanism of Credit Control.

The ability of the Central Bank to realise this important and comprehensive programme of social utility which it has to perform must depend on the recognition of the fact that there is a general as well as special mechanism for credit control and that its discount rate has influence on the credit situation and on the general level of prices. The attainment of comparative stability of prices and the smoothing out of the disordered economic machinery can never be accomplished without an effective discount rate policy. Changes in discount rates are no longer due to mere changes in the gold

[1] Prof. Foxwell says, "its chief duty is to the business-world rather than to its shareholders and its chief purpose to maintain financial security and stability rather than to make profit."

reserve alone but the state of bank deposits and the condition of short money market, the state of employment, the state of the capital market, the stocks of commodities, the state of gold movements, the level of internal prices and the conditions of foreign credit, the nature of exchange activity and the prices of speculative stocks, and the pressure on foreign exchanges are some of the criteria for varying the official discount rates of the Central Bank.

## The Modus Operandi.

The *modus operandi* of the means and machinery of credit control has to be understood before it can be opined that Central Banking management can be successful in realising the important and comprehensive programme of social utility and the central planning of the economic machine. The bank rate has influence over the quantity of bank credit and regulates effectively the supply of the created bank media of payment and hence the price-level.[1] The bank rate policy tends to protect the gold reserve by regulating the rate of foreign lending. A rise in the bank rate means the interest rates are higher and a flow of short-loan funds would take place from the other international financial centres. Again a rise in the bank rate may tend to discourage investment relatively to saving and lower prices thus reducing the entrepreneur's profits who are accordingly forced to offer less employment.

[1] See J. M. Keynes, "Treatise on Money," Vol. I, Ch. 13, pp. 185-220.

But the Central Bank finds its task unnecessarily complicated and rendered difficult owing to the individual unco-ordinated action of the Joint-Stock Banks. These go on merrily discounting commercial paper, finance bills and transact all kinds of banking business mainly with an eye to their profits. They do not recognise that the Central Bank has to ultimately provide cash for all their operations. Thus the Central Bank is drained away of its money for no fault of its own. The market rate of discount is never controlled during normal times [1] and inasmuch as the commercial banks possess larger amount of deposits than the Central Bank itself they can undercut its rate and attract all business from the Central Bank. But the time comes when too many finance bills are discounted or when a bout of unhealthy speculation has to be checked or when there is a desire to strengthen the movement of foreign exchanges, or when there is the necessity to control the gold movements, or when it is considered necessary to stimulate declining business activity or when there is an aspiration to realise the

[1] This is not however the case with the Bank of France and the Reichsbank. They always do discounting business to a large extent. It is also true that the Bank of France discounts bills of even very low denominations. The above-mentioned statement holds good in the case of the Bank of England. So far as Germany is concerned the special rate of the Reichsbank is binding on the other banks after it has reached 4 per cent.

[2] For a considerable part of the year when there is no excitement and when business is not abnormally active the Bank of England practically does not discount business whatsoever; see the London Statist, June 10th, 1899.

wider ambitions of Central Bank philosophy changes in bank rates become imperative.

### The Open Market Operations.

In order to make the change in the bank rate effective and insure implicit obedience on the part of their followers the Central Banks pursue the "open market operations," *i.e.*, buying and selling the Government securities with the view of replenishing or exhausting bank credit accommodation. Greater reliance is now placed on the open market operations of the Central Bank than in the past.[1] The Macmillan Committee indirectly argues for the stability of the bank rate for by its frequent oscillations traders and industrialists are being taxed unnecessarily.[2] The greater holding of free gold and liquid assets by

[1] The power to enjoy the open market operations was definitely sanctioned when the U. S. District Court dismissed the bill of complaint of one F. G. Raichle which sought to question the capacity of the F. R. Banks to conduct open market operations. See W. J. Weston's "The Economics of the English Banking System," p. 83.

[2] This exactly was the grievance of the British industrialists and they point out exultingly to the stability of the bank rates of France and Germany. But the Bank of England has no such large gold holdings as these banks and as these do not practise international deposit banking nor hope to maintain a free gold market nor have an extensive bullion market to be protected there is no necessity on the banking department which is the weaker of the two. The provision which forces the Bank of England to buy gold at £3 17s. 9d. per standard ounce has also been a contributory cause in his opinion. As Bagehot says, "the Lombard Street is by far the greatest combination of economical power and economical delicacy the world has ever seen." Being the money market of the world calls for capital are frequent and fluctuations inevitable. It has long been recognised that a partial remedy for the state of affairs was to increase the reserve of the Bank. See also R. F. I. Palgrave's "Bank Rate and the Market Rate."

the Central Bank would protect the banking system from frequent fluctuations in the bank rate. These would also increase its power of effective control over the money market.

But banking theory which supposes that rates of discount are altered according to demand and supply considers a high rate of discount as a sign of active trade. An unalterable and stable rate of discount is the result of stagnation of capital and industry; whereas frequent oscillations indicate a rapidly increasing prosperity of the people and great improvement in industry and commerce. Frequent oscillations of the discount rate are due to the unceasing vigilance of the Central Bank and its attempt to discharge its duties faithfully as the guardian of the credit structure. While granting that it is the duty of the Central Bank to promptly check every monetary disturbance from the normal and provide the community with a steady flow of purchasing power it should not make bank money artificially scarce [1] on the ground that short-period changes in the bank discount rate do not really cause trouble to the bankers and traders. [2] When open market operations would be

[1] Prof. Foxwell says, "The true test of sound economic as distinguished from merely solvent banking is the moderation of the average rate of discount."

[2] In actual practice many effects are realised by a change in the bank rate. Granted that there is a rise in the bank rate the rate of exchange rises. The maturity of money due to foreign countries is postponed. New liabilities of foreign countries to home country are created by increasing export of commodities. It tends to lower the prices of stocks and merchandise. It raises the market rate of the country.

useful at such time as seasonal expansion of credit mere changes in bank rates to achieve the self-same objective are futile.

### Other Usual Operations of Central Bank.

For an effective control of the money market the Central Bank must have even during normal times some considerable commercial activities such as buying and selling bills and investments. Otherwise there is not the desired effective control. Without the maintenance of stable credit conditions the healthy interests of businessmen, industrialists, traders and the general public cannot be secured. As soon as these operations are being conducted the commercial banks raise the cry that the Central Bank is effectively competing with them with the help of their own interest-free deposits.[1] Besides the possibility of securing steady volume of business and the coming into touch with the money market there is the assurance of earning enough income though not to be distributed as reasonable dividends but at any rate to cover its working expenses.[2]

The F. R. Banking system however has organised other means for controlling credit in a somewhat detailed manner although it is admitted even there that credit is inherently unstable. Dr. Spahr points out that

[1] Since these lines have been written Mr. Kisch develops this argument in his evidence before the Hilton-Young Commission. See also his Central Banks, p. 104.

[2] The Kemmerer Vissering Commission had to add substantial duties to the Reserve Bank of South Africa in order to make it earn its own expenses and a reasonable profit to boot.

" the *general* mechanism of credit control aims at supervising the fundamental elements of credit structure such as the note-issue, the clearing system, the relation to the Government and the eligibility of rediscountable paper. The *special* mechanism is for injecting speed and accuracy into the responsiveness of credit changes to the needs of business at a given price level." [1] The specialised mechanism includes " the rediscount rate, the open market operations, the rationing of credit, the regulation of the amount of notes, persuasion, warnings, and refusal of the reserve banks to rediscount eligible paper." Almost all these instruments were indeed tried vainly to check the speculation craze on the Wall Street. This experiment in credit control could not succeed. It was controlled only by an examination of the profit position of the corporations and the only controlling factors over the value of the stocks and shares soon began to exercise their influence. [2] So it easily follows that no one Central Banking system has as yet created a set of machinery for controlling the entire credit structure. Success or failure in this respect would lead to the realisation or otherwise of orderly economic progress on the part of the country.

At times of falling prices the banking system finds it difficult to make its policy effective. The lowering of the bank rate to a ridiculously low figure even would

[1] See W. E. Spahr's " The Federal Reserve System and the Control of Credit," pp. 128-130.

[2] See my article " Central Banks and Speculation," The Calcutta Review. See Appendix II.

not succeed in making businessmen borrow. It is clear then that there is a limit to the reduction of the bank rate.

### On Real and Effective Competition.

While repeating the above charge the ordinary banks are taking too one-sided a view. The modern Central Bank has lost its sting altogether. [1] The Central Bank by refusing to undertake risks and insisting upon a high banking standard finds its loaning business greatly curtailed. As O. W. Sprague puts it "the good quality of the assets in general is important because it gives that prestige which is half the battle for the Central Bank."[2] It has been completely overshadowed by the big commercial banks which vary the ordinary rates of discounts and loans according to the strength and character of business offered and their own cash reserves. The Central Bank rate, being high, not much business is attracted and except when there is a stringency due to intense trade or speculative action, there is no resort to the Central Bank. This Central Bank acts as a reserve bank in order as P. Leroy Beauliau says "to save the public at the opportune moment from the ruin which might result from the blunders of the

[1] This is the case with all the European National Banks. The three D's in Germany are more powerful than the Reichsbank. In France and England the big banks virtually command greater resources and hence dictate the money rates in the money market.

[2] O.W. Sprague—"Chapter on Central Banks," Dunbar's History and Theory of Banking, 4th Edition, p. 89.

private banks." No Central Bank is now run purely with the view of earning dividends. The credit policy of the Central Bank is never swayed by private interests, *i.e.*, considerations of earnings.[1] Prof. Foxwell expresses the self-same idea somewhat tersely when he says that "the duty of the Central Bank is more to the public than to the shareholders."

### Excessive Reliance on C. Bank.

Another grievance aired by the public on account of the close relationship of the banks with the Central Bank runs as follows :—It is tempting the commercial banks to reduce their balances far below the safety limit and depend on the protection afforded to them by the Central Bank. Most of the commercial banks do not keep more than 15 per cent. cash reserve and it is indeed no exaggeration to find that some of the more venturesome banks depend on ten per cent. proportion of cash and when the call comes they rediscount their bills with the Central Bank.[2] Individual self-protection was hitherto the guiding motive. But as mutual

[1] Even Governor Strong of the Federal Reserve Bank of New York says, "The F. R. system is not run to-day with a view to earning money. That notion has entirely disappeared. There would be no criticism if we made no earning for the next two years. Earnings are not an influence in fixing our credit policy." Sir Ernest Harvey, Comptroller of the Bank of England, says, "The Bank of England considers its duty to be similar."

[2] The French Banks habitually keep a small amount of cash and depend on the liberal rediscounting policy of the Bank of France. In England the practice is to withdraw call money and the bill brokers run up to the Central Bank to secure the needed resources for repayment of the short-term loans.

relations between the banks have become more cemented the threatened bank is virtually supported by the other banks for they know full well that the strength of the banking chain depends on the weakest link. The failure of one bank might involve them all in a common ruin. The Central Bank takes the lead and all the other banks help as much as they can to prevent a complete disaster.[1]

### The Dangers of Inflation of Credit.

Another grievance of the public is that the Central Banks are not in a position to check credit inflation. It is undoubtedly true that the ordinary banks are interested in the extension of their own credit. They like better a regime of high prices, industrial expansion, booming trade and flourishing commerce because there would be wide demand for their credit during such times. The banks would like such expansion of credit but their power to expand credit is strictly limited by the charges they make and they cannot be adequately checked by the Central Bank. There are

1 Such instances of help can be multiplied to any degree. The first case of mutual action under the leadership of the Bank of England was noticeable during the Baring Crisis of 1890. The most recent example of national help to a struggling bank can be seen in the aid rendered by the Austrian Government and the National Bank to resurrect the business of the Credit Anstalt. The failure of the Banque Oustric and Banque Adam meant widespread destruction to several depositors and these had to be helped by banking co-operation secured by inter-banking arrangements. Quite recently two Norwegian Banks were forced to suspend business and as a result of central banking help a re-organisation of their assets is being made to enable them to resume banking operations after the three months' moratorium period.

however practical limits up to which the joint-stock banks can increase their credit. As their loans increase, the cheques drawn against the banking accommodation would have to be 'cleared' by the lending banks in the clearing house and their reserve at the Central Bank would diminish. Those banks which have lent indiscriminately would soon find their reserve becoming exhausted than the more cautious banks and until the Central Bank is willing to help them this expansion of credit cannot be continued for a long time. The Central Bank is not powerful enough to check the initial expansion of credit brought about by the joint-stock banks. But no credit organisation has been in existence which can automatically prevent inflation. Even the advocates of "managed currency" who consider that monetary stability can be secured by wise control of the banks over co-ordinated credit institutions of the market have to realise that the efficaciousness of the bank rate weapon depends on a prompt and effective use of it. As one writer says, "Any delay in the use of the weapon might give scope to a rise in the price level and it might be accelerated beyond restraint." [1] Secondly, the ordinary banks should understand the meaning of the step[2] undertaken by the Central Bank and join hands with it to make the movement

1 R. G. Hawtrey, "Monetary Reconstruction," pp. 123-124.

2 The Macmillan Committee remarks, "above all it is desirable that the clearing banks should be made aware in the plainest possible sense whether the general tendency of the policy of the Bank of England at any time is towards a relaxation or towards a contraction of the conditions of domestic credit." See para. 374.

succeed. Accurate information as regards the work and operations of the banks is needed. A proper system of consultation and co-operation between the Central Bank, the semi-public financial institutions and the commercial banks is needed. The degree of aloofness and remoteness which characterises the ordinary relations between the member banks and the Central Bank has to be given up for one of close co-ordination and collaboration so that the credit-controlling policy of the Central Bank might become fully effective.

Even the socialists who desire the nationalisation of credit on the plea that credit which the banks lend is a social creation and hence it should be socialised or nationalised have failed to devise a proper scheme for securing a prompt expansion of credit and due contraction of it whenever necessary. Ordinarily, the Central Banks have the power to control undue extension of credit by changes in the bank rate, the open market operations and moral persuasion or advice to the member banks of the money market. It has already been stated that the expansion of credit cannot be so easily secured by the Central Bank even though it pursues the policy of "cheap money" deliberately maintained by artificially low money rates whatever might be the controlling action of the Central bank it is the bounden duty of the commercial Banks themselves to be wise, sober and prudent in their day-to-day management of the credit structure. It is during days of credit inflation and risky business expansion that banks have to be extremely cautious in extending credit.

It is the duty of the cautious banker during such times to convert his assets into a liquid condition, pay off his borrowings with agent or correspondent banks, clear up bills payable to the Central Bank. He should suggest a similar plan of action to his business customers and dissuade, as far as it is possible for him to do, large extension of capital, heavy comitments of raw material, large labour force, over-extended and too liberal credit terms to his customers. It is just the opposite line of action that the banker has to pursue when there is business depression. Gilbart rightly says, " the banks should be wise in the time of speculation. But to act wisely in a season of speculation, *crises or any emergency* is far more difficult than to act wisely in one of pressure. Unless a banker acts wisely in the previous time of speculation his wisdom will probably be of little avail when the pressure arrives." [1]

## Mutual Co-operation.

With the progress of time, one finds better and closer relationship among the several banks and between the Central Bank and the ordinary banks. The supposed clash of interest between the commercial banks and the Central Bank does not really exist. There is " no proper basis " for competition now-a-days. The Central Bank is viewed purely as an emergency bank from whose hands any amount of banking accommodation can be secured for legitimate credit

1 G. W. Gilbart, " History, Principles and Practice of Banking," Syke's version, p. 310. Italics mine.

purposes on the security of sound collateral whose liquidity is of an unquestionable character. As one writer remarks, " the Central Bank is the spring from which the water of life wells up. The commercial banks are the pipes and channels by which it is conducted to a thirsty economic system." Thus viewed there is no scope for misunderstanding. The dual objective of the modern banking system is not only to provide purchasing power of stable value but to act as a store of capital. Conant says, " union among the banks and the accumulation of cash reserves in a Central Bank are making banking credits in commercial communities a secure means of storing capital." Banking business is becoming perfected and bank credit stands on a par with metallic money so far as the services of storing capital and the medium of exchange are concerned. The more progressive bankers understand the seriousness of their occupation and the enormous secondary consequences flowing out of their primarily selfish action. Though they still hanker after profits their anxiety to serve the needs of the public is also a factor that counts. The banks are willing to devise methods to satisfy the legitimate needs of their clients expeditiously and cheaply realising full well that the clients' property means their own prosperity. Thanks to the economists and monetary reformers the banks are fast becoming alive to the fact that they are not mere dividend-paying machines but higher and nobler instruments to dispel poverty, increase production, secure better distribution of wealth and stabilise the centrally

planned economic machine of modern industrial society through their policy of credit control, creation and management.

The recent war has taught the banks and the public many lessons. The utility of the centralised banking system has been proved to the hilt. Even the U.S.A. Banking system has at last been re-organised on the Central Banking plan. Other countries have followed suit and the present-day endeavour of the modern countries is to create a Central Bank of Issue where such a thing does not exsist. So long as it does not harbour paternalistic tendencies and so long as it is under experienced management there is no evil resulting out of this form of highly integrated banking system working under the inspiring guardianship of the Central Bank. The Clearing House, the maintenance of the one reserve system, the influence of the bank rate and other credit devices of the money market and the influence of the Government Treasury would increase the unifying influences [1] and make the entire banking system of the country a single financial unit. The conception and idea of Central Bank's credit-controlling policy have gained the approval of scholarship and of authority. The need for joint-action under an able leader during the periods of crises, unemployment and speculation has been adequately realised. It has also been proved that

[1] In co-operation with the British Treasury the Bank of England has devised an excellent system of paying interest on War loans at varying times in order to steady the flow of banking credits and debits.

Government help during the acute stage of paralysing panics is a desirable and efficacious thing. The inflationary and deflationary periods following the wake of the recent war have set all bankers a-thinking. Bankers are taking keen interest in the general financial welfare of the country. Bankers are now being considered as social leaders of great importance and their explanatory commentaries on economic events are tending to broadcast sound economic knowledge. Their advocacy of the gold standard has been specially of much value and the recent return to the gold standard (1925-1928) by all the countries is a step resulting out of their advice and exhortation. [1] A day might arrive when the fond dreams of Saint Simon and Auguste Comte might be realised and bankers might wield all political power in a well-governed community. Before this cherished and desirable consummation can be brought about the banker should realise his duty towards the community. The banker should cultivate his sense of social obligation and organise his economic and credit services and structure in such a careful way as insure maximum usefulness to society.

*Select References.*

1. B. R. Rau, "Present-Day Banking in India."
2. B. R. Rau, "Banks and the Money Market."

[1] If the prominent bankers agree to popularise the idea of the goods standard it would undoubtedly become popular. For the defects of this standard see Appendix III.

3 L. D. Edie, "Banks and Prosperity."
4. J. M. Keynes, "Tract on Monetary Reform," "Treatise on Money."
5. J. S. Lawrence, "Stabilisation of Prices."
6. C. H. Kisch, "Central Banks."
7. R. G. Hawtrey, "Monetary Reconstruction."
8. W. R. Burgess, "Reserve Banks and the Money Market."
9. Gold Delegation Committee of the League of Nations—First Report, Second Report and Final Report.
10. B. R. Rau, "Organised Banking in the Days of John Company."

# CHAPTER VII

## Section III.

### The Bank of International Settlements and India's Duty towards It.

Though it is mainly intended as a bank for the commercialised payments of German Reparations as formulated by the Young Plan yet it is possible to secure lasting good out of this new financial institution possessing unique responsibilities.[1] It is a pity that the American Government have practically administered a rebuff to the ideals of co-operation involved or underlying [2] the B. of I. S. by refusing to pronounce its own benedictions on this proposal. [3] Future monetary stability all over the world and an intelligent management of the gold standard are some of the ulterior

[1] Even Prof. Keynes admits that it might become a Supernational Bank if only it sheds its general financial business—Treatise on Money Vol. II, p. 404. The World Economic Conference of 1933 proposes to widen the powers of the Basle Bank and introduce a compulsory system of co-operation with the other Central Banks of other countries.

[2] The word International can be aptly used as its daily business is conducted in four languages, English, Italian, French and German. Its officers belong to ten nationalities. Its short-term investments are scattered all over the globe. Its capital is subscribed to by Central Banks of 26 countries.

[3] The Federal Reserve Board is not directly represented on the B. of I. S. But a powerful banking group of the U. S. A., sends its representatives to participate in the management of the B. of I. S. It has been recently decided to allow the F. R. system to be represented on the Directorate of the B. of I. S.

effects if the proposed bank is made to work on sound lines. As important momentous consequences would flow out of its successful working more details of this bank should be understood.

## Some of the Earlier Proposals.

At the Brussels International Financial Conference of 1920 which was so prolific of highly ingenious schemes the first well-conceived suggestion for an International Bank was made. Monsieur Delacroix suggested the creation of an International Bank to issue interest-bearing bonds in exchange for "genuine securities such as rights over customs duities, harvests, mineral products, or any produce from which a return can be foreseen within a relatively short time and allow the redemption of a bond at a not too distant date." [1]

A more grandiose plan than the above was the plan of Carl Thalbitzer to start a Bank of the League of Nations to "fill the gaps in International financing" and "arrange refining and other credits where existing banks cannot offer their services." A new international unit of account called the "league" was to be established and the parity of its value with gold is to be maintained by this bank. The capitalisation of the bank was to be secured by subscriptions "payable in gold or in currencies at the rate of the day."

1 See Papers 12 and 13 read before the International Conference, Brussels, 1920.

The apparent defects of both the plans were soon realised and these schemes were given up as "romantic" "precious" suggestions. Nothing tangible resulted out of these discussions.

## The Reasons for Starting the Present Bank.

The immediate reason for the inauguration of this bank was to facilitate the making of the new reparations payments on the part of Germany. [1] It was created to supplant the old Transfer Committee under the Dawes Plan. The commercialisation of reparations payments collected in Germany which have to be transferred to the foreign countries and payment to the creditors in their own currencies is the main object of the bank.[2] Though the commercialisation of reparations payments

[1] The Young Plan stipulates for the payment of an average sum of £100,000,000 a year until 1965. From 1965 to 1985 average payment was to fall to £50,000,000. It drops to £45,000,000 in that year and by 1988 the reparation payments have to cease altogether. See the Economist, 3rd August, 1929.

[2] The B. of I. S. receives the German annuity payments and executes the distribution of these payments to the creditor countries. It receives from the German Government the certificate of debt which specifies the annual amounts payable by Germany. On 15th day of each month the B. of I. S. receives the equivalent of 36·5 mil-dollars a month. These are received in currencies called for by B. of I. S. Some portion is payable in Reichsmarks which are used to finance deliveries of commodities to the creditor countries.

Similarly it undertakes to execute Inter-allied debt payments on behalf of Hungary, Bulgaria and Czechkoslovakia to their creditor countries.

Under the trusteeship function of the Bank can be arranged this task of receiving and disbursing payments on behalf of international loans floated by Governments.

is the primary object yet it is to exist as a purely commercial or non-official financial institution not subject to the control and political pressure of any Government of any country. It is created to exist soley as a medium for organised financial co-operation [1] between the different Central Banks of the world.

Secondly, its formulators have wider and more ambitious aims and wish the B. of I. S. to realise the wider issues. It is meant to act as a "Central Bank for the Central Banks." Even if this bank were to confine itself to the business services of a "Clearing House" for the Central Banks it would undoubtedly realise this ambition. But the framers of this scheme wish to place rediscounting powers in the hands of this Super-Central Bank so that many tangled questions of international debt remittance and international debt repayments to the U. S. A. [2] are to be

[1] The Committee of experts who formulated the scheme and organised the Bank say, "we have attempted to set up an institution whose direction from the start shall be co-operative and institutional in character, whose members shall engage themselves to banish the atmosphere of the war, to obliterate its animosities, its partnerships, its tendencies, phrases and to work together for a common end in a spirit of mutual interest and good will".

[2] That some such thing has ultimately to be devised becomes clear. If Europe can afford to pay its indebtedness to the U.S.A. it is impossible for these countries to expect this settlement of debt by gold payment alone. Commodities cannot be sent by the debtor countries as there is a high tariff wall in America. Either it has to scale down the tariff duties or agree to receive the payment in kind or consent to overlend as in 1926-1928 period to Germany sums which are far greater than interest payments in which case it would be easy to pay temporarily the American indebtedness. As neither of the alternatives can be carried out it is quite possible to expect the proposed Bank of I. S. to arrange

accomplished by the new bank. Acting as a reservoir of foreign exchange it can render help to any Central Bank of any country. If one remembers how the Central Bank of France by holding large foreign exchange holdings agreed recently to support the dollar-sterling exchange the essential utility of the world reservoir of foreign exchange can be grasped easily. The stabilisation of exchange within normal limits of gold points can easily result out of a successful working of the scheme. Abnormal fluctuations in exchange can and ought to be checked by gold transactions in the gold stationed in the hands of the B. of I.S.

Thirdly, it would indirectly cement the ties of close relationship between the different Central Banks[1] as there would be no encroaching on the field of work of any existing Central Bank or any of the investment banks of the existing countries where it might be represented. If cut-throat competition is eliminated the new institution is bound to receive hearty welcome.

Fourthly, a successful discharge of the second and the third functions would enable the new bank to

for the liquidation of settlement of indebtedness to America. Payments in kind which might be sold to other countries would lead to foreign exchange holdings which can later on be converted at a stable doller rate into dollar currency by this bank. The payment of reparations according to the capacity to pay and without endangering German currency is the object of starting this International Bank and the recent settlement of the reparations payments (1929). If the Lausanne Conference were to succeed it would put an end to this situation. The B. of I. S. will have to perform the non-reparations payment functions alone.

[1] See the Report of the Gold Delegation of the Financial Committee, para 194. The maintenance of international equilibrium without the sacrifice of national interest ought to be the guiding motive of the B. of I.S

help the stability and re-organisation of the banking systems of the newly settled countries. Some sort of financial federation of the different nations is to be evolved.[1] Economy of gold and still further concentration of it in its hands would be its advantage. Whatever might be the actual gold production itself or " the statistical position of gold " as the economists term it the new bank would bring about substantial economy of the yellow metal by dispensing with several unnecesssry movements of gold. A lesser production of gold in the near future and the continued monetary demand for gold on the part of the nations would lead to disastrous effects on the general world price-level. The mercantile acquisitiveness of gold by nationally-minded States might create deflationary tendencies but the International Bank can by co-operation with these Central Banks check the evils arising out of such situations. Intelligent control over the world value of gold would greatly be facilitated by its action in this direction and the financial Committee of the League of Nations would undoubtedly facilitate its work by co-operating with this body. It can point out how the Central Banks of the different countries can regulate the volume of internal currency and stabilise prices by stabilising the value of gold. So long as non-monetary causes such as over-production

1 The following statement from the Protocol makes this clear: "It is to promote the co-operation of Central Banks and to provide additional facilities for international financial operations and to act as trustee or agent in regard to international financial settlements entrusted to it under agreements with the parties concerned. See article 3, Chapter I, of the statutes of the Bank.

tend to disturb the general world price-level of commodities the B. of I.S. cannot indeed hope to eliminate the economic disequilibrium arising out of such non-monetary causes. Such monetary causes as excessive gold nationalism and maldistribution of gold might lead to financial crises and depression of world prices. The B. of I.S. can hope to correct these by securing a better distribution of gold or by granting credit or by enabling the Central Banks of other countries to dispense with the necessity of "free gold" over and above the safety margin. [1]

The present-day tendency amongst the Central Banks is to hold excessive reserves in the gold centres. The B. of I.S. can facilitate clearing business between the Central Banks and render unnecessary the vast holdings of large stocks of foreign exchange reserves. It can thus perfect the machinery of the gold-exchange standard system to a great extent.

Lastly, the harmonisation of political interests even would be secured by its action. It can afford to act as a mighty engine promoting international peace goodwill, and amity amongst the different nations.

[1] Sir J. C. Stamp says that shortage in the future supply of gold can be counteracted by the B. of I.S. which can create a safe superstructure of international credit. The Bank of International Settlements might one day say, "Here are countries A.B.C.D. who are not doing as well with the gold reserve as we know from experience they could depriving the world unnecessarily of a much-wanted supply. We will ourselves construct on the basis of gold deposited with us, a supplementary supply of credit to equate, to negative, to offset, to correct those faults in those errant nations." See his Lecture before the Stable Money Association, 6th June, 1930, at the Harvard Club, New York City.

The internationalisation of finance [1] is a potent and practical means of disarming the nations and creating the " international mind " and the needed goodwill to secure peace.

## The Organisation of the Bank.

The total issued capital was 100 mil. and one-fourth of it was called up at first, *viz.*, the actual paid-up capital was $25 mil. The different Central Banks or banking groups of the following seven countries were given the original privilege to subscribe to the shares.[2] The present Board of Directorate consists of the Governors of Central Banks and nominated members possessing requisite commercial, industrial and financial knowledge and 25 directors assemble to conduct its deliberations.

The Head Office of the Bank is in Basle, Switzerland. Freedom from local taxation and a suitable legal status have been granted to the bank.[3]

[1] W. H. C. Laves says, " The Bank of I.S. should be the international financial organisation caring adequately for the interests of the debtor nation and world order as a whole, just as the Mandate system to-day attempts to look after the welfare of native populations and international well-being." See The American Political Science Review, August, 1931.

[2] The Central Banks of Sweden, Switzerland, Holland, Austria, Bulgaria, Danzig, Czechkoslovakia, Finland, Greece, Hungary, Poland and Rumania have also been invited and they have subscribed shares. The original members were the Reichsbanko the Banque de France, the Bank of England, the Banque National de Belgique, the Bank'd Italia, the Bank of Japan, and a Federal Reserve Bank or some other American financial institution.

[3] See Articles of the Charter granted by the Swiss Federal Government.

Adequate provision for the formation of reserve fund has been made by the by-laws which insist that quarter of the profit will be added to the reserve fund of the bank until it forms half of the paid-up capital. After reaching this position one-tenth of the profits is to be added to the reserve till it is two times the paid-up capital and so on according to section 4 of chapter XI of the Bank Charter. Provision for a dividend of six per cent. is made and the surplus profits have to be disposed off according to the above plan.

## Some Details of Its Working.

Broadly speaking, there are three main departments in its structure. The Banking division consists of those departments which conduct foreign exchange business and the receipt of deposits and the making of investments. The second department deals with the relations of the B. of I.S. with the Central Bank. The conducting of research in monetary problems and the centralising of information are parts of its duties. The third department is the Secretariat General which deals with administrative duties. The bulk of its deposits consists of the deposits of Central Banks as regards their foreign currency reserves and deposits on behalf of their treasuries are also made by the Central Banks. The paid-in capital and permanent deposits arising from the Hague Agreement substantially augment the total working capital. Neither Governments, nor individuals, nor private banks can make any current account deposits with the B. of I. S. if the Central Banks of their countries were to object.

The securing of the bank's assets is subject to the fundamental aims it means pursuing. These can be recounted as (1) the regulation of the exchange, (2) the acting of a reserve centre for Central Banks, (3) the improvement of world credit by facilitating international credit and the free circulation of capital.

What are its achievements ?

Although it is too early to decide how far it has realised its aims and objectives still it must be candidly admitted that something notable has been achieved in the two following directions. Firstly, it has greatly tended to facilitate the international flow of the short-term funds into the long-term capital market.[1]

Again its short-term investments are distributed all over the world and in such far-off centres as Tokio, Rome, Prague, and Helsingfors. Though full one-third of its working capital consists of fixed deposits payable at the end of 37 years the time length of its investment never exceeds over 2 years. Roughly $\frac{1}{10}$ of the deposits is invested for a period of six months. The bulk of the investments is purely of such character as are payable at sight or within three months. The main motive of the investment policy is not to gather profits but to facilitate world trade and commerce. The aim is to "move capital from the superabundant markets to those centres where it is actually needed. The equalisation of the interest rates at the different

1 See the article on B. of I. S., Twenty Years Hence, p. 39 *ibid.*

centres is another main objective. The movement of funds is sometimes done expressly to help these currencies which are also executed in such centres where credit instruments are entirely lacking." [1]

Secondly, there has been vast improvement in the field of international central banking co-operation. Hitherto the sole practice among the Central Banks was to maintain deposit accounts with one another and exchange credit information if needed. The practice of earmarking gold, of investing foreign balances for each other and of exchanging information also existed. Instances of mutual help and co-operation existed since the nineteenth century. [2] But the B. of I.S. performs this work and is now "the outward visible sign of systematised and organised Central Bank co-operation.[3]

[1] See the articles entitled "The First Six Months of the B. of I. S.," by G. W. Mcgarrah, President of the Bank for International Settlements in the Proceedings of the Academy of Political Science, Vol. XIV, January, 1931, Number Two.

[2] The Bank of France oftentimes helped the Bank of England and other C. Banks of Europe. The Financial Committee of the League of Nations help the currency re-organisation of several countries and inter-Central Banking co-opration was one of the methods used to stabilise the lira, the zloty and drachma. The Informal and Secret Conferences of the Governors of the Bank of England and the F. R. Bank of New York, the Bank of France and the Reichsbank carried the tendency a step further. The 1927 Washington Agreement was entered into with the sole object of C. B. co-operation. No C. Bank is to embarrass the gold holding of another C. Bank by withdrawing its balances from it.

[3] See Articles 20 to 25 for the business which can and which cannot be transacted by the B. of I. S. See Charter of the Statutes.

But no attempt has thus far been made to increase world trade by financing such projects in undeveloped countries which would lead to the development of foreign trade. With the acquisition of long-term deposits the Bank of I. S. might form a Syndicate for developing world trade. This promoting activity has not yet been taken up. For the present it is confining itself to trusteeship agency work and Central Bank business. But Governor Norman's apprehensions are indeed justifiable. He wisely remarks "there are vague references to all sorts of things which might be done towards rebuilding the world. How they are ever to be carried out I have not the slightest idea. What they precisely mean I do not know; they are continually mentioned especially by those countries who feel the need more than others of some further development."[1]

What about the future ?

Even if the reparation payment were to be completely executed and its primary object smoothly and efficiently discharged[2] the B. of I.S. will not be wound

[1] See his evidence before the Macmillan Committee, Vol. II, p. 298.

[2] Since these lines were written there has been a pronounced fall in prices and Germany has pleaded inability to pay the conditional part of the annuity. The Young Plan removed the clause in the Dawes Plan which made explicit provision for variations in the gold price-level. The B. of I. S. promptly appointed the Basle Committee to draw attention to this feature of abnormal fall in prices and the consequent inability of Germany to pay the reparations payments as a result of unstable economic conditions. A committee of Governmental experts would soon examine afresh the inter-allied indebtedness problem. Either a writing down of the debts would take place or a rising level of world prices would be engineered or consciously ushered.

up. The other functions will remain as the main objectives and the B. of I.S. will remain as a constructive guide to the Central Banks in the field of international credit co-operation. It can easily act as a missionary of sound finance in international matters.

But the task of making reparations payments could act as a drag in the initial years of its operations and would tend to place it under the guidance of expert economists and officers responsible for the payment.[1] As the London Statist puts it it has acquired a spirit of hostility and suspicion which has surrounded the reparations payments which is being manifested in the petty squabbles for the location of the bank.[2] The outburst of nationalism on the part of the States would create difficulties.[3]

Secondly, the possibility of political influence being exerted has to be reckoned. So long as the power

[1] The Lausanne Conference has almost killed the reparations payments and War Debts are "about to be killed." See my paper entitled Economic Implications of the Lausanne Conference, 14th September, 1932, read before the Bengal Economic Society.

[2] See the Statist-International Banking Supplement, 1929. Since these lines were written the political payments are about to be written off completely as a result of the Lausanne Agreement.

[3] Sir C. S. Addis says, "The broad internationalism of the Bank of I. S. is a source of weakness as well as a source of strength. For no two nations argue in the same plane and there is always the danger of attributing to bad faith some misunderstanding which may really have its origin in differing political constitutions.....Its members must learn to comprehend and respect the views of others and to acquire the art by no means an easy one of accommodating the national temperament to international uses." Proceedings of the Academy of Political Science, January, 1931, No 2, Vol. XIV, p. 103.

of appointment of officials is in the hands of the Central Banks the elimination of political influence can be expected but it might not be realised in actual practice.[1] Thirdly, the financial circles of London are somewhat jealous of the Super-Central Bank. They are naturally anxious for the maintenance of the world's financial leadership in London as before. Devoid of the American Government's moral support it is bound to have reduced strength and if London's financial interests become apprehensive they would easily undermine the influence of the new bank. But if the new bank confines itself to the pure functions of a " Clearing House " and " Exchange Reservoir " and act as a " helpful factor " in the matter of enabling nations to pay their international indebtedness there is no reason why it should rouse the jealousy of the financial interests of London. Neither its growing acceptance business nor investment business is going to be adversely influenced. London's financial hegemony over the British League of Nations as its Economic Empire is termed is certainly not at stake.[2] So long as the real spirit of the terms of its constitution is understood and adhered to and no encroachment on the business of the C. Banks of other countries is forthcoming in actual practice there would be no re-

[1] France tried to secure its nominees on Board so as to allow her to succeed in her political ambitions by making the B. of I. S. a tool in its hands. This attempt was frustrated as nominees of C. B.'s of neutral countries were selected to the Board in April, 1931. See Paul Einzig's " Behind the Scenes of International Finance," pp. 63 to 65. See also his 3rd Edition of the Bank of International Settlements."

[2] This is the fear expressed by Dr. W. A. Shaw.

sentment nor retaliatory action which might tend to reduce its prestige and lower its influence.

## Its Definite Goal.

In the words of the ex-Vice-President Sir C. S. Addis the considered monetary policy of the bank is stabilisation of world prices. " The Board of the B. of I. S. will perform " a great public service " as he says, " if they do no more than carry on an intensive examination of the dangers of monetary instability and the possibilities of devising means for its mitigation or cure." As Sir Joshiah Stamp aptly remarks, " What it may safely do lies in the unknown future but the fact that it is a framework and a safe edifice in which thought and experience may proceed and progress is one of the saving features in a situation which is darkly threatening the very basis of civilisation itself. It may in due course develop its own technique to remedy great shortage of credit in particular nations, by concerted action it may do for all what no one could do for itself." [1]

Quite recently, it passed a resolution recommending the early adoption of the gold standard by all the nations of the world. [2] The uniform reduction of Central Banks' reserve ratios can be secured out of its initiative.

## India's Duty.

The moment the Reserve Bank is started it should apply for membership to this body. Any extra gold

[1] See his Papers on " Gold and the Price Level," p. 38.

[2] See Resolution, dated July 11th, 1932, of the Board of the B. of I.S.

resources needed to start the Reserve Bank need not be obtained by floating a loan in the L. M. Market but an appeal to the B. of I. S. is possible. The primary duty of the Bank is to assist the Central Banks of other countries when they attempt to restore the gold standard. As such India's request for a gold loan cannot be vetoed.

Possessing a stabilised currency and working on the gold bullion or the gold exchange standard basis India can hope to become a share-holding member of the B. of I. S. This would be the case as soon as the present linking with paper pound sterling is unlinked and India reverts back to a gold standard. Indian nationals versed in finance, exchange and currency matters might be deputed as representatives of the Indian banking system.

The statutes of the Central Reserve Bank should permit it to count the current account deposits it makes in the hands of the B. of I. S. as part of its statutory reserve. Having given the status of gold reserve to these deposits it should not shrink from exercising the rediscounting [1] privilege so that an elastic system of credit expansion can be raised in

[1] On June 25th, 1931, the B. of I. S. granted a rediscount credit of $100 millions to help the Reichsbank. As the whole of this credit became exhausted within a month the financial crisis of July, 1931, could not be averted. The rediscount rate of the Bank of I. S. will not be a single figure but a code of figures applied to different C. Banks at different moments. To stabilise the international price-level a judicious use of the rediscount rate would make the B. of I. S. influence the trend of the international price-level. See Paul Einzig, Bank for International Settlements, Ch. XI

this country when needed by the exigencies of trade demand. Short-term loans can be secured on gold or approved short-term securities which are of course currently marketable. This process would enable the C. R. Bank to make a fuller use of the gold reserves than would otherwise be the case. Some of the investment funds might be handed over to the B. of I.S. for securing ideally safe international investments.

The earmarking of gold and the use of credit granted by the B. of I. S. would also facilitate the payment of our international indebtedness without shipping actual gold. So long as the gold exchange standard system [1] based on London currency is worked London would be the best external centre in which our exchange reserve has to be piled up. If this were to be the case the above earmarking of gold would be unnecessary. But if an independent and real gold bullion standard were to be in operation this method of clearing international indebtedness would be extremely helpful.

The Reserve Bank has to act as the agent and correspondent bank of the B. of I. S.

The C. R. Bank would undoubtedly gain much by securing a real insight into the international monetary situation and credit problems. The exchange of information and advice itself would be very valuable.

Apart from the advantage of participating in the cumulative distribution of the profits of the bank Indian economy stands to be benefited in several ways.

[1] The recent Report of the Gold Delegation has done substantial service in the direction of popularising the pre-War G. E. standard as a useful currency system for many countries. See paras. 215 to 221.

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# CHAPTER VIII.

## The Problem of Banking Stability.

The meaning of the problem—Banking stability as the present-day goal—Universal banking instability—Causes for the epidemic of bank failures—The harmful consequences of banking failures—Some attempted remedies :—(*a*) U. S. of America. (*b*) Germany. (*c*) Norway—Ths *rationale* of these above remedies—Concluding statement.

## The Meaning of the Problem.

Any well-organised society is often blessed with diversified banking institutions which specialise in their particularly chosen field of credit. Between the Central Bank of Issue at the top of the banking hierarchy and the humblest credit institution there are several types of banking concerns, such as commercial banks, savings banks, mortgage banks, industrial banks, co-operative banks, etc. Banking strategy consists in not only securing effective co-ordinated service at the hands of the different banking units, thus maximising their economic utility to society, but

the different units of the entire banking structure ought to conduct their respective internal banking operations almost unimpeded in spite of an adverse foreign financial situation. A concrete example will enable the reader to visualise my meaning. The instances of Canadian and British banking stability during the present world crisis can be quoted as chosen and well-meant examples of banking stability.

If we survey banking system from distant Peru to far-off China we find almost every banking system assailed by several factors leading to instability. Frozen assets, difficulties created by the suspension of the gold standard, the withdrawal of short-term foreign balances from the money markets, the impeding of the free import and export of capital, the restriction of the imports into the country and abnormal methods to control adverse exchanges, and banking suspensions and failures are the order of the day. Hardly a week passes before it is announced that one important bank or another has been forced to close its doors. The consequent distrust of the domestic banking system and the recrudescence of the hoarding habit are the twin characteristic features attending on the present world-wide banking instability. Witness the passionate appeal of President Hoover to the American citizens to give up the hoarding of currency and bank notes. The French citizens are mindful of the fact of political instability arising out of the breakdown of the economic machine in several important debtor countries of the world and are disinclined to make long-term investments of capital as before even

through the banking channels as it used to be their habit in the pre-war era. In spite of Governor Moret's advice nothing has been accomplished in this direction and the flitting of these liquid short-term funds belonging to France from one international centre to another is one grave cause of international financial instability and the banking systems of these countries which practise international deposit banking are becoming subject to severe strains and stresses to meet the sudden withdrawal of these funds.

### Banking Stability as the Present-day Goal.

"The old order changeth yielding place to new" said the poet-laureate Lord Tennyson. At different times of banking history different goals have been placed as the Mecca of banking faith and aspirations. The early nineteenth century ideal was to build a banking system which was almost panic-proof.

The latter-day nineteenth century ideal was to build a banking system which was crisis-proof. A well-known French banker said long ago as follows:—"All that the Central Banks can do is to avert the extremes of crises and depressions. But this is not new. The Bank of France tried to do it for a hundred years before the War."

The present-day ideal can be stated in the following language. The Central Bank's primary policy is to build a knave-proof and failure-proof banking system. It is to be considered as part of the duty of the credit statesmanship of a Central Bank. It is often stated that "in a period of declining business activity

the function of a bank of issue is purely negative." [1] But this opinion has to be combated seriously for mere negative policy will not prevent the banking system from a severe crash as soon as the business depression becomes acute. True wisdom consists in forsaking this negative policy. Sir Charles Addis rightly remarks, "It is simply intolerable that Central Bankers should continue to sit with folded hands while industry and trade throughout the world are becoming the sport of our ineffective monetary systems. We must be masters in our own house, the rulers and not the slaves of money." [2] The individual banks as well as the entire banking system ought to be free from disgraceful failures. As prevention is better than cure the positive aspect of banking strategy as wielded by the Central Bank should be in the direction of achieving banking stability.

Banking concerns are collapsing like houses built of cards or are going down like ninepins in almost every country of the world. The recent Report of the League of Nations on the World Economic Depression comments on this feature of bank failures thus. "The number of bank failures varied largely with the conditions of banking in the different countries. Figures available for the U. S. A. show that bank suspensions which amounted to less than 500 in 1928 rose to 650 in 1929 and 1,350 in

[1] The Federal Reserve Bank's Annual Report of 1930.

[2] Sir Charles Addis, Address before the Bond Club of New York, 24th November, 1930.

1930. In the early part of the latter year an epidemic of failures, largely confined to small banks in rural districts, broke out in the Middle, West and South. Some banks in the large commercial centres also went into liquidation. In the first half of 1931 the number of bank failures was 728 as against 542 in the same period of last year. Special difficulties had to be dealt with by banks in countries where large sums were tied up by the financing of stocks of commodities which depreciated in value or by large credits to industries which became frozen during the depression. In countries where there exists a close connection between banking and industry especially central European countries industrial credits became frozen to a serious extent. Owing to this factor combined in some cases with the withdrawals of foreign credits certain banks of importance in Central and Eastern Europe were forced temporarily or permanently to cease operations".[1]

Commencing with the failure of the Credit Anstalt of Austria and [2] other financial institutions such as the Verkersbank, the depositen, the industrie and the Union, noted banks commanding large resources, have been going to the wall all the world over. The

[1] P. 187.

[2] The Government and the National Bank undertook to render financial aid to the Credit Anstalt but the collapse of German finance and the depreciation of the pound sterling and the economic decay of Austria have made it impossible on the part of the Government to make good their promise. It is more or less in a state of suspended animation and hundreds of millions of Schillings have been lost as a result of bank failures.

recent failure of the U. S. Bank of America reminds us that banks are not immune from collapse even in the land of that *El Dorado*. The collapse of the Darmstadter Bank on the 13th July, 1931, and a host of 170 smaller banking institutions in the first nine months of 1931 is the most recent staggering phenomenon exemplifying an almost universal feature arising out of world-wide causes such as economic depression and business recession. The recent reconstruction of the Dresdner Bank cannot be considered as a mere example of the rationalisation movement in German Banking. The revivification of the Schroder Bank of Bremen, the granting of financial succour to the State Bank of the Rhine province and the recent inauguration of the Guarantee Bank[1] can be considered as salutary examples of inter-banking co-operation and the spirit of *entente cordiale* that ought to prevail in the banking structure of any country.

Even in France the failure of the Banque Oustric and Banque Adam meant widespread destruction to several depositors and these institutions had to be helped by banking co-operation secured by inter-banking arrangements.

Quite recently, two Norwegian Banks were forced to suspend their business as a result of immobilisation of their commercial and industrial advances.

[1] An acceptance and guarantee bank was recently started by the Reich and the Public Banks, 25 % of its nominal capital of 200 mill. Reich marks has been paid up. Its duty is to certify eligible bills for the Reichsbank by buying them in the first instance from other banks and the savings banks.

## Causes for the Banking Malaise.

Before being called upon to state the cause of these troubles in the banking industry the desperate nature of the present-day situation cannot be visualised until it is brought home to the minds of the readers that no similar situation ever arose in the annals of financial crises throughout the last century and many important banks of international reputation have failed. The Central Banks were able to solve the situation and mitigate the economic rigours of these panics. During 1825, 1836-39, 1860-66 and 1893 exceedingly interesting examples of banking instability occurred in more than one country. Even international aid was promptly rendered to avoid the threatened collapse of the domestic banking system of more than one country. But no equal parallels can be cited which closely resemble the present-day banking situation or informal debacle of 1932.

The present unfortunate situation arose out of the sad failure of the American speculative craze of 1927-1929. A number of factors peculiar to the American situation were indeed responsible for wholesale failures of the American country banks during the years 1930 and 1931. The advances on securities proved to be "frozen assets" and made many of the banks vulnerable and unstable. Lacking adaptability they have been slowly deteriorating with the result that the banking and currency committee of the House of Senate presided over by Senator Glass are seriously thinking of overhauling the F. R. Banking structure

with the view of adding more powers to the F. R. system to enable it to integrate the banking structure and enable the F. R. Banks to control the vast array of the smaller banking concerns numbering 22,000 in all. The intense promotional activity on the part of the banking subsidiaries or holding company is a special local cause peculiar to America alone. This is no less responsible for the gloomy and adverse situation than the general trade depression which is more or less a common world cause. The isolated and indifferently managed local banks, depending on one single industry they have aided are the greatest sufferers.

### The Harmful Consequences of Bank Failures.

The failure of threatened banks a phenomenon so universal now in all debtor countries of the world means the breakdown of the credit of the world machinery and a staggering set-back to the capitalist industrial economy of these countries. A bank failure means instability on the part of its depositors to pay their creditors. These will be unable to pay their creditors with the result that the vicious circle tends to encircle the whole society. An important bank failure means a thorough shaking of the whole banking system. The strength of the banking system of any country depends purely on the weakest link in the banking chain. The inability of the debtor countries to repay their indebtedness means the precipitate failure of the erstwhile rich creditor countries. The international repercussions

## Banking Suspensions.

*(Deposits millions of dollars.)*

| Year. | Total Suspensions. | | Member Banks. | | Non-Member Banks. | |
|---|---|---|---|---|---|---|
| | No. | Deposits. | No. | Deposits. | No. | Deposits. |
| 1921 ... | 501 | 196 | 70 | 43 | 431 | 154 |
| 1922 ... | 354 | 111 | 57 | 24 | 297 | 86 |
| 1923 ... | 648 | 189 | 24 | 51 | 524 | 137 |
| 1928 ... | 491 | 139 | 73 | 42 | 418 | 96 |
| 1929 ... | 642 | 235 | 81 | 57 | 561 | 129 |
| 1930 ... | 1345 | 865 | 187 | 380 | 1158 | 484 |
| 9 Months of 1930 | 675 | 287 | 88 | 70 | 582 | 217 |
| 1931 ... | 1234 | 929 | 268 | 391 | 966 | 538 |

See the *Statist*, November 14th, 1931, International Banking Supplement.

* * * * *

of the failure of Germany, of Russia or the Central European countries brought about by the insolvency of their banking system are almost unthinkable. World trade, finance and industry would languish. The mantle of proverty would be drawn over all the countries. The comparatively rich creditor as well as the poor debtor countries would be enveloped in a common whirlpool of disaster and ruin. The complex industrial civilisation is bound to end fatalistically for a failure of a big bank directly

affects many enterprises and a big bank's failure means loss to several depositors and misery to a large number of people in the community. Banks are the acknowledged feeders of agriculture, trade, industries and many other key enterprises of the community. The entrepreneur's incentive becomes lost and world business enterprise would become restricted if international banking instability were allowed to continue unchecked. The mainspring of the present-day economic activity is the realisation of profits and when different human efforts are being expended in vain without the realisation of profits, the incentive for all action becomes destroyed. Unemployment, a shrinking of the purchasing power and a slow repercussion on all other productive activities would result.

Thus the different economic activities would slowly dwindle to insignificance and thereby arrest the clock of economic progress of the country. Hence a sound and well-managed system and elastic banking has to be developed in each and every country.

### Some Attempted Remedies.

It has been stated already that this movement commenced in Oct., 1929 in the U. S. A. The prices of stocks and shares fell. Speculation began to dwindle. Interest rates began to rise. Industrial commodity prices began to fall. The volume of employment shrank. Unemployed bank money increased. Bank rates have gone down. But the psychological gloom and pessimism attendant on the businessmen's minds

have not been lifted as yet. The depression has not yet lifted and conditions would remain at this stage till banking stability is assured. So long as bank assets remain immobilised their cry for moratorium becomes insistent. President Hoover realised this long ago and has inaugurated the National Credit Corporation towards the end of Oct., 1931. The banks are asked to poll two per cent. of their deposit money and raise $500 million by this joint action. The National Credit Corporation is to rediscount *all sound but frozen* long-term assets of all banks which cannot at present by virtue of F. R. Banking laws, be rediscounted at the hands of the F. R. Banks.

Assets worth $4,000,000,000 are frozen up and of this colossal amount about $1,500,000,000 worth of frozen, assets are in the hands of failed banks. Even the first mortgage of real estate has tended to become frozen thereby creating an embarrassment to all. The newly created corporation would seek local guidance before these frozen assets are discounted by it. Thus many banks having insufficiency of cash may revive their business and activity.

Another wise measure which unfortunately has been discussed but not been adopted is the branch banking system. Observing the marked safety of the English and the Canadian banking systems the conclusion is arrived at that an encouragement of branch banking on a wide scale would somehow avert the avalanche of banking failures. Branch banking is at present permitted only to a limited

degree. Of the 48 states only 9 permit unrestricted branch banking; 22 positively prohibit it, and do not take notice of this tendency at all and the remainder permit their banks to have branches in towns where the main head office transacts its business.[1] As a result of such circumstances roughly there are 22,800 unit banks and only 800 operated branches throughout the length and breadth of the U. S. A. country.

But the American people have circumvented this position of legislative hostility by adopting fusions or amalgamations and encouraging the "chain system" or "group" banking as it has been styled in banking parlance. About 300 groups are in operation and they control 2,100 banks in all. About one-fifth of the entire banking operations of the country rests in the hands of the group system. This is nothing but a tacit recognition of the advantages of integrated banking. Wisely conducted branch banking tends to diversify the assets and distribute the risk amongst several borrowing concerns. Nothing conduces towards banking success as the realisation of these twin ideals.

Germany has attempted to reach the banking millennium or haven of safety by instituting a banking control board which has been tacked on to the Reishsbank organisation. Briefly speaking, the object is to supervise and inspect the position of German

1 See the Mysore Economic Journal, Jany., No. 1932, Article on the U.S.A. Banking position. See also " The Branch Bank question " by C. W. Collins, 1926. The arguments for and against the adoption of branch banking in the U. S. A. are carefully stated.

banking institutions in general. While it must be admitted that strict control over details of banking organisation is impossible the amelioration of the general banking conditions becomes possible through this step. Banking resources can be rushed to the danger spot and the fire can be stopped in time before it becomes a widespread conflagration. Timely help and effective assistance are indeed postulated on the part of Central Banking authority. The general banking situation can be eased and improved to a great extent by this timely action which has to be undertaken by the State or Central Bank or inter-banking machinery.

The Norwegian banking system has attempted to solve the problem in a different manner. The usual three months' moratorium is granted and the Norwegian Central Bank has helped them to amalgamate with each other. By reconstructing their assets during the interrugnum of the moratorium period the amalgamated bank hopes to revive its business as usual. The underlying aim of this action is to restore public confidence as soon as banking stability tends to be assailed. The prevention of panic psychology on the part of the depositors and creditors of the bank is the secondary objective. A brief period of respite is granted and the bank, provided it is essentially sound, gains breathing time and might succeed in regaining solvency. An insufficiency of cash or immobilisation of assets can be remedied by running up to the emergency bank for help whose cardinal principle of help is to assist

the sound and struggling bank alone and allow the insolvent bank to go to the wall. This process of elimination will lead to the survival of the fittest.

### The Rationalb of the Remedies.

First, let me consider the widely-held view "that branch banking conduces to banking stability." Branch bank *versus* Independent local bank is an old well-worn out issue in banking theory. Historically speaking, the evolution of banking progress in most of the countries has been from the local bank to the big bank with numerous branches. At times of threatened danger the local banks amalgamated with each other and tided over the situation. A wisely conducted and efficiently managed big bank can confer several advantages on the customers, the bank officers and the general public. As I have stated elsewhere "the opening of branches will afford an outlet for the surplus capital at the head office and minimise the danger of its being invested in hazardous undertakings. They afford facilities for the transmission of money from one place to another and can easily bring about a proper distribution of capital according to relative needs of time and space. Uniform rates of interest can thus be easily secured. The small traders can be educated as to the advantages of a banking account. The branches will afford the best possible professional training ground for young people desirous of a new career. Expenses of management can be economised. The opening of branches all over the country would lead to an elimination of the banking risks involved in financing industries to a great extent. A branch

bank can spread its loans over several industries which an independent local bank cannot hope to do. The various branches will give ample facilities for gaining accurate information of the credit standing of the customers. The branch bank system may be easily extended to places too small to support a regular bank which requires a full complement of officers and reserve of coin. A unified policy is possible during periods of emergencies. The system of clearing would become simple and effective and a greater use of cheques might also be expected."

But there are some disadvantages of the branch bank system. " Each branch is a source of weakness and loss at one branch may lead to a run on the whole establishment of which the branch is only a part. The branches may tend to rival the older establishments of the place, if any, and this rivalry may lead to the lowering of the banking standard. There may be a falling off in the nature of securities against which banking accommodation is sought and overbranching may lead to overbanking and the extreme rigour of modern competition will force the numerous branches to tout for unsafe and risky business. Too many branches and all of them working under rule of thumb methods will tend to stifle intelligence. The provinces might tend to view the draining away of their resources to the metropolis with disfavour. Delay in the matter of granting of loans would result to a certain extent as the necessary reference to the Head office to complete the transaction would indeed take some time."

"An effective audit and weekly reports of business to the Head office would eliminate most of the above disadvantages. Clever training at the Head office would produce efficient officers having the necessary experience to run the branches with success. An efficient peripatetic supervision by the managers and directors of the banks would obviate slackness of work on the part of branch officers. Local businessmen might be enrolled as advisory officers to help the branch managers in the matter of granting loans and gauging the personal credit of the customer. If the branches are established in response to actual demand, if they follow strictly the legitimate duty of attracting deposits, if they confine themselves to mastering the credits of their customers, if they keep down expenses to a low level and if they eschew any rivalry with the existing older banks and be amicable with new rivals that may enter the field there is no reason why the branch banks should fail and cause ruin to the parent bank."[1]

The success of the Canadian Chartered Banks cannot be mainly attributed to this concomitant feature alone. The helpful conventions pervading the entire banking structure have to be realised. Each customer has exclusive dealings with one bank alone. The conception of *one man one bank* is strongly enforced so that credit is not abused by the borrower. Secondly they insist that "a full and detailed statement of the customer's affairs should be made once a year to the

[1] See my Present-Day Banking in India, ch. on "Banking Organisation."

bank. The banks insist that they should begin with *a clean slate* at the beginning of each year. Nextly, the banking profession is manned by men who are thoroughly well-versed in banking policies and traditions. The local managers of branches besides making daily, weekly and monthly reports of the state of banking business have to furnish a report surveying the state of the local industries, agriculture and business conditions. Considerable latitude in the matter of loaning is usually given to the branch officers and it is seldom that their recommendations are cast aside. While the local officer stands to gain by the authority and wisdom of the Head office placed at his service, the Head office itself seldom overrides their suggestions before having an interview with the local officer on the particular issue awaiting its sanction. Such constant interviews with local officers and the habit of touring round the branches to see in person the nature of the work turned out makes the directors of the Head office alive to the necessities of the areas and their particular local needs. Accurate facts as regards local, political, commercial, industrial, agricultural and financial affairs can be easily secured thereby. The Inspector General of banks and his supervising office is mainly responsible for checking the mismanagement of the officers of the Chartered Banks.[1]

The highly integrated character of the English Banking system and the efficient credit control exercised

[1] As a result of the failure of the Home Bank in 1924 this effective public supervision was instituted by the federal Parliament as against the wishes of the Canadian Banker's Association.

by the Bank of England are due to " prestige of crystallised tradition, freedom from political snipe-shooting, relief from the burden of defence, the support of Government deposits, the exclusive possession of bank reserves, the concentration of banking power, the size of the country, the density of population and its state of economic progress and finally the identity of interest of the great bank and the commercial and financial community which it serves, afford the most favourable auspices under which a Central Bank might embark on a policy of credit and price control."

Both the Norwegian and the German methods are only an elaboration of a well-known practice common in all banking circles. During the period of a financial stringency or a crisis the banker suffers from a shortage of cash or legal tender money and the banker is not liable for a miscarriage of the currency system and it is the duty of the State and the Legislature to provide relief measures during such times. No individual bank is strong enough to undertake such measures and on the State falls the duty of providing the means of payment. Any tardiness or belated action on the part of the State would intensify the situation and bring about a general suspension of cash payments on the part of all financial institutions. On the Central Bank, which is the medium of State action, falls the important task of restoring order and reducing financial chaos.[1]

[1] See J. S. Lawrence, " Stabilisation of Prices."

While this collective and co-ordinated action is necessary to support the banking system in the hour of its trial, the ordinary attitude of the individual banks during normal times should be "forward-looking and be such as to avoid failure or prevent a crises." A failure may arise either out of insolvency or an insufficiency of cash and a sharp distinction has to be drawn between the two cases. Insolvency arises when the liabilities of the bank are far greater than its assets. If excessive loans are granted to individuals who have failed to pay, if there is fraudulent management on the part of the bank officials such as the cashiers, clerks and accountants and if there is injudicious banking, the assets of the bank are liable to be lost or destroyed and there remains little to meet the liabilities

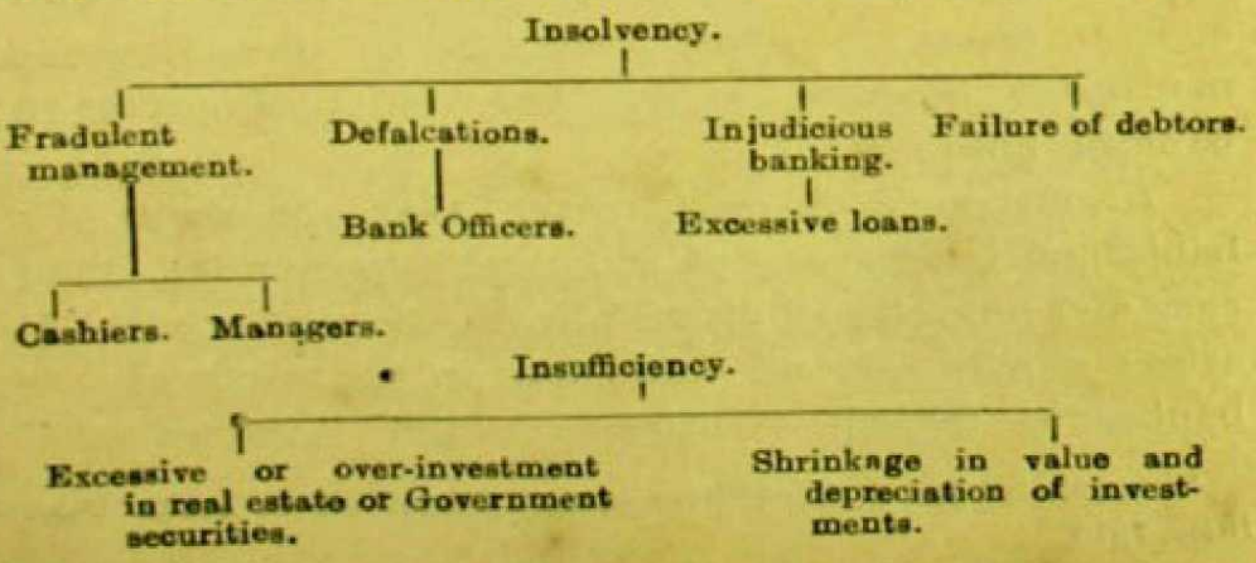
Banks should be thoroughly solvent. Their asset should exceed liabilities by a decent margin and in addition to this fact cash should always be available to discharge demand liabilities. This double feature of solvency is the *sine qua non* of all banking business. Mere solvency in the sense of possessing just enough assets to cover liabilities as in the case of mercantile business is not the criterion of success in banking business.[1]

Insufficiency of cash means that the assets of a bank have become locked up thereby preventing their easy and prompt mobilisation in the hour of need. It arises chiefly out of confusion in the minds of the banker as regards "ultimate" and "immediate"

[1] See the Report of Lord Farringdon's Committee on Trade Facilities, 1916.

convertibility. The assets should be immediately convertible into standard gold currency or legal tender cash but in the case of banking companies it is both "immediate" and "ultimate" convertibility that is to be aimed at. In this case a failure may arise but in as much as enough assets exist there is no loss and harm to the depositors. Only the bank loses its own reputation and has to close its doors. Prompt help by the Central Bank or a Clearing Bank's Association may retrieve the whole situation and avoid failure. Such help can be granted only after a correct ascertainment of the solvent position of the bank.

Insufficiency of cash may be due to the bank's not maintaining an adequate cash reserve in proportion to its liabilities. It may also arise if loans are made on mortgages of real estate or if money is lent for a long period, if unsound business of other banks is taken up or if a shrinkage in value and depreciation of its investments takes place affecting the position of the bank. The following tabular statement would illustrate how insufficiency or insolvency may arise:—



A prudent banker has to guard against insolvency as well as insufficiency of cash. By all means the banker should be in a position to provide banking facilities by advancing on short-dated bills or on collateral security. He should on no account confuse this duty with that of providing financial facilities by granting long-term advances on securities. This is the duty of the investing public. During normal times every individual banker is expected to be solvent and in a position to pay back the demand liabilities he has undertaken. When there is no financial crisis in the money market the banker should not suspend his cash payments for it is nothing short of breach of faith and it practically amounts to a confession of failure to conduct banking business on sound lines.

*Concluding Statement.*

Coming nearer home, the suspended animation amounting almost to failure of the small loan and banking companies is a noticeable feature. The suspension of the activities of the Dawson's Bank and the People's Bank of Northern India since September, 1931, call for no comment at my hands. Many of the smaller banks and bank-like loan companies are unable to weather the storm without experiencing great discomfort. Hard times, lower banking dividends and declining advances are the features of the day. Lack of trade demand, absence of industrial activity, depreciation of gilt-edged stock and a peculiar political situation are causing embarrassment to one and all.

Partly by bad luck, partly by the failure of the banking system to be wise in the past and partly by world causes a grave situation has arisen. I am not so pessimistic as to suggest that a wholesale collapse of the banking system is about to take place. Banks which occupy leading positions like the Imperial Bank of India in the Indian banking system are altogether sound. Their solid assets and the availability of cash resources are welcome features. But during the interval that has elapsed since I tendered oral and written evidence before the Central Banking Enquiry Committee many things have occurred which make me feel that a thorough reorganisation of the banking system on the lines of the modern Central Reserve banking practice is an inevitable step which cannot be delayed any longer. Individual banks themselves have to pursue a better selective policy in making short-term investments and a stricter watch over advances in the internal field. Banking stability and the resultant economic progress are factors worthy of very great risk and enormous sacrifice.[1]

1 A paper read before the Institute of Bankers—Calcutta Centre—Published in the Mysore Economic Journal, May, 1931.

# CHAPTER IX.

## The Problem of Credit Cycle and its Control.

### *Meaning of Credit.*

From the banking point of view credit means the creation of debt by someone to another individual. When bankers speak of the creation of credits it means nothing else than the creation of debtors and creditors. There are as many debits as credits and the respective sides of the bank's balance-sheet expand proportionally. When a bank creates credit it means a bank deposit or a particular type of credit which is being created. Bank credit is thus a glorified actor in the arena of modern business. The business transactions of modern society purely depend on the health and vigour of the chief actor.

### *An equilateral triangle.*

A recent writer explains the importance of credit by drawing an equilateral triangle, the three sides of which are represented by credit, consumption and production.

### *The position of credit.*

These sides of the triangle are mutually co-expansive. Credit holds the key position and the others are interdependent factors. The transfer of credit permits the interflow of goods from production to consumption. Although the hygiene of credit has not been mastered as yet still it is patent to everybody that at times all sides of the equilateral triangle may increase or decrease. Such an instance of all-round activity could

be noticed during the recent new era days of prosperity—(1925-28) in the United States of America.

*Lack of equilibrium.*

More often the position of disequilibrium manifests itself when one side unduly lengthens or shortens or lags or leads in expansion. The lack of equilibrium continues till they fall in step and move closely hand in hand. This situation can be illustrated concretely by the following supposition.

*Overproduction.*

It is almost a truism to state that entrepreneurs in charge of production speed the progress of economic activity as soon as they expect increased demand for their marketable goods. Production forges ahead. Additional bank credit stimulates this activity. Bank advances become locked up in shape of fixed or investment capital. No hitch does arise if consumption responds and effective demand exists for the increased goods. If however, consumption does not respond a stock of unsold goods would result out of this psychological optimism. As their hopes are not being realised they immediately discern serious jerks in the flow of trade. A modest fall in prices is engineered to tempt the consumers but this anxiety itself on the part of the entrepreneur makes the consumer higgle further so that there is further checking of demand. The seller withdraws from the market in the vain hope that prices would rise as a result of shrinking supply. The buyers however anticipate further fall which they hope to engineer by further desisting from entering the

market. Thus a further fall of prices ensues. A battle royal can be practically witnessed and the see-saw movement between bullish and bearish sentiments would baffle any accurate description. In course of time a natural level is reached and consumption is once again stimulated till it reaches a normal stage. But the infirmities of the entrepreneur would once again initiate a similar cycle of events. Thus credit becomes overworked as a result of entrepreneurial suggestion and banker's willingness to lend a helping hand to their erstwhile customers.

*Capital Inflation.*

The course of a representative credit cycle arising out of credit infirmities can be depicted as follows :— " Firstly, there is a capital inflation leading to an increase of investment and a commodity inflation results. Secondly, there is still more capital inflation and commodity inflation for approximately one-production period leads to that of consumption goods. Thirdly, there is a reaction in the degree of commodity and capital inflation and finally decrease of investment below normal takes place leading to commodity deflation.

*Consumer's Vagaries.*

A credit cycle arising out of the vagaries of consumers would be riotous as it was the case in the days of new era prosperity in America. Riotous living leads to good times in certain types of industries. There is too fast and uneven investment of capital in fixed forms ; there is rapid change, economic development and unbounded optimism. But a stage ensues when there is

the failure to earn interest charges even. There is a fall in prices and business failures ensue. Even Government revenue shrinks. There is uniform curtailed profits all along the industrial line. Industries work on a restricted basis. There is widespread unemployment among workers. A panic ensues. Food riots mark the depth and intensity of misery prevailing in such disturbed times. There is the weeding out of weak concerns. Forced adjustment to new conditions takes place during the times of enforced liquidity. A fresh point of equilibrium soon arises and the course of cycle repeats itself afresh.

*Central Banks' watchful Activity.*

These entrepreneur's mistakes and countries' overproduction of raw materials by Dame Nature cause industrial fluctuations. Credit infirmities and consumers' vagaries have to be detected in due course of time by the Central Banking structure. An entirely useful Central Banking policy consists in checking abnormally active credit or unduly heavy credit contraction. Its activity as well as volume, (*i.e.*), as I have stated elsewhere, the quantitative as well as qualitative character of credit have to be vouchsafed. Though a permanent bureau of the Central Banks might attempt to study the conditions of excessive or deficient and subnormal activity of credit still the economic conditions of society make the effective control over the continuously operating credit oscillations an impossible thing to be carried out, much less realised in actual practice. As a result of constant shift in the three different sides of the triangle the price-levels

become irregular in their trend. In the language of economic science " the periodicity of price changes is not harmonic but is subject to irregular d isharmony." Monetary policy and credit control mean firstly, the understanding of the cause of the price changes, secondly, the discerning of the means or measures to detect changes in price level and finally, the attainment of relative stability of society which is not unduly subjected to several stresses and strains.

*Seasonal Variations.*

Economic theory classifies price changes under the following five headings. Seasonal variations confined to the limited span of one year, the short cyclical wave which runs over three years, the long cyclical wave covering a much longer period, *viz.*, ten years—secular changes which run over 40 to 50 years and abnormal fluctuations such as those occurring during war times.

Beginning with the last item it can be immediately grasped that no possible restraining influence can be exerted on the upward swing of the price-level. While the evils of uncontrolled inflation can be abhorred yet no remedy has been suggested beyond the undertaking of fixing of maximum and minimum prices and commandeering peace-time industrial activity to war-time basis. The other well-known methods of remedying the extreme evils of inflationary prices are the practising of thrift and the rationing of necessary commodities of life whose price has risen high. Rise in general price-level can be checked by controlling exports as well as imports. The fixing of prices

which are revised from time to time is only an anxious desire on the part of the State to make fixed price cover the cost of production. Sometimes Governments might aquire the commodities produced in a whole lot. Thus these different examples of price-fixing are ample proof of the fact that the State has to protect the community from the evils of high prices brought about by whatever cause it might be. Fiscal pressure, commercial factors, expansion of commercial banking credit and low interest rates tend to defeat the realisation of the above desire and its cherished consummation. Until other forces aid the action of the State the return to normal industrial activity does not take place. Contraction of commercial bank credit, consumer's strike, rising interest rates, the cessation of forward buying, and the balancing of budgets would lead to the return of normal conditions which govern prices.

*Seasonal Price-changes.*

It is known almost to every student of economics that seasonal variations in industrial life occur in a country where great variations in temperature can be felt. That building and iron industries are markedly seasonal in nature needs no elaboration here. So are winter clothing and woollen manufacturing industries. The industrial life in provision and oilman's stores business is markedly regular when compared with the above industries. During bad times of economic depression the loss of these industries becomes deplorable. Price-changes do not govern seasonal industrial activity. As a matter of fact no economic barometer which can truly

indicate industrial prosperity can be pointed out. Not even the loan rate can be thought of as guiding industrial operations during these brief periods.

### *The Short-term Cyclical Wave.*

The short-term cyclical wave extends beyond a longer period than the seasonal variation does. Prof. Fisher and other economists have already pointed out the lag between the loan rate of interest and the real rate of interest. The peering into the future is denied to the ordinary man and the entrepreneur fails to calculate exactly the new means of production which are needed by society. The decision of the savers who ought really to determine the rate or pace of economic progress has no influence on the situation. Either the State or the entrepreneur sets the stage of industrial activity and creates the new means of production or the creation of investment-capital goods is undertaken by them. The bankers or the credit purveyors act as mere middlemen and respond to their call or initiative. There is unequal distribution of investment and a few major industries become over-capitalised and overdeveloped. The moment the bankers detect this situation they begin to restrict credit. The hopes of entrepreneurs are nullified by the fear of the bankers for the safety of their credits. At any rate no new bank credits are extended to these overdeveloped industries. A higher interest rate is sometimes demanded to check marginal demand but all borrowers stand penalised under this arrangement. The uncertainty of the future acts as a deterrent on normal

economic activity. Even stock-exchange quotations begin to accurately reflect the economic behaviourism of the community. The economic balance or equilibrium stands disturbed. Activity becomes restricted. Unsold stocks and raw materials are offered for quick sale as industry has to cover operating expenses at least. Commodities are sold even below their prime cost and the greater the bank pressure for the return of the previous loans the more accelerated is the tendency for the drop in the price-level. Enforced liquidation sometimes becomes the prevailing feature. The progress of writing off losses has to be faced with equanimity. Wages have to be reduced. The other various items of cost of production must have to be drastically curtailed so as to cope with the abnormal fall in prices. The longer this process of readjustment takes place the longer would be the time taken for the restoration of economic equilibrium. The same set of facts emerge once again as soon as the new equilibrium point is reached.

*The Long-term Cyclical Wave.*

The longer cyclical waves cover a period ranging from seven to ten years in length. Very often a succession of 2 to 3 short cycles would be experienced within the period of the longer cycle. Economists subdivide the long cyclical period of 1921-1931 into three short cycles of 1921-23, 1925-27 and 1928-29. The trend of events is unmistakably the same everywhere though the exact sequence of cause and effect might not be repeated in the same order.

### *Secular Changes.*

The secular changes in price-levels occur once in a period of fifty to sixty years and economists speak of it as a "structural change in industrial life." Gold production and population growth are the chief explanatory causes. But the economic historian who studies political and social development can no longer incline to the view that secular changes tend to occur once only in very long periods. He draws an interesting parallel between human life and industrial life. The seasonal period of industrial life is rightly compared with the working hours of the day. The short-cyclical industrial movement can be compared with the day; the long cyclical wave with the week; the secular wave with the year and the industrialisation period varies with the whole human life. This has been the experience of every important country. The U. S. A. witnessed for example 20 cycles of varying intensity within the whole course of the 19th century. The experience of every industrial country organised on the acquisitive capitalistic basis is the same or tends to be similar.

### *Testimony of Keynes.*

Prof. J. M. Keynes admits the kaleidoscopic character of economic events. The changing nature of economic facts in the credit cycle is pointed out by him in the following cryptic remark: "The possible varieties which a credit cycle can follow and its possibilities are so numerous that it is impracticable to outline all of

them. One can describe the rules of chess and the nature of the game, work out leading openings and play through a few characteristic games but one cannot possibly catalogue all the games which can be played." Engaged in the field of productive industry and actuated with the motive of securing economic progress the entrepreneurs as well as the bankers fail to realise the wider perspective. The individual planning of the capitalistic machine tends to aggravate and prolong the troubles of the cycle of economic depression. There is no systematic co-operation between demand and supply with the result that capitalistic society is sometimes faced with either a glut or overstocked market or else there is a scarcity one. Neither situation augurs well for the future. The period of recovery from maladjustment to the one of normal economic equilibrium is unduly prolonged, as a result of planless working on the part of the industrial machine. The attainment of economic equilibrium between society's investment and saving has to be done or rightly estimated. Savings have to be properly garnered by the banking machinery. If the rate of investment is forced to move in unison with the above factor the credit cycle will disappear. Investment goods and consumer's goods have alike to be produced in sufficient quantities and nothing further in the direction of maladjustment can indeed take place. The attainment of economic equilibrium rests in the hands of bankers who have to provide such volume of credit as is needed and at such a rate which will cause the value of investment in fixed, working or liquid capital to be in equipoise with the rate of savings

Provided profits which are often the balancing economic factors in economic calculations and business-operations do not influentially misdirect investment there is no reason why steady normal or average economic progress should be denied to capitalistic society. The individual entrepreneur himself must exercise his foresight and adaptability during all stages of the economic depression or boom. But the banker can however go far in alleviating the misery of the different sections of society during acute depression by helping the state to act as entrepreneur. While state enterprises should be of a complementary nature to private enterprise still they should not be such as to divert capital from the foreign market. It can be confined safely to spheres which are real public needs and which have been neglected by private initiative so far.

### Labour's part.

The consolidated labour organisations ought to strive after the ideal of *a mobile or plastic wage policy* instead of monopolistic fixed wage policy out of tune with actual industrial conditions. That changes in wages should follow changes in prices is the infallible economic law, the course of which might be delayed but the policy of wide-awake trade unions ought to be the realisation of this idea.

### Commercial Agents.

Nextly, the commercial agents or middlemen are the distributors of goods and services. They can smooth out the unnecessary disturbances in industrial life. They however depend on economic information

and economic statistics would check misjudgment. The press must disseminate accurate information and create a right kind of economic atmosphere so that disproportioned production does not arise.

### Consumers.

Again the consumers or the general public determine production while entrepreneurs govern development by their initiative. During good times increased foresight in the investment of capital and in borrowing is needed. During bad times the public should not live beyond its resources. Prof. Taussig's excellent exhortation to the consuming public can be borne in mind and it runs in the following language: "Keep as much as you can to the even tenour of your way. Do not spend recklessly, do not be stingy. Do not waste and do not hoard. Help your neighbour, help your community, help your country by making all the contributions you can for alleviating distress. Your gifts for charity and for public use will help, even though they are palliatives, not remedies. Things that bring some relief from pain and misery are as much needed in industry as they are in medicine. In your daily life avoid excess, live your own sober, steady and normal life. By so doing you help to steady business life and help it into the course of enduring health and prosperity."

### The Central Bank.

Finally, it is the Central Bank that can make proper and timely adjustments of the bank rate of

discount and check the rising phase of the cycle. A gentle cyclical revolution or a relatively slight depression might exist and it can moderate the pace of present-day delayed crisis or prolonged depression. During times of disturbed psychology and panic in the money markets bank credit must be obtainable.

Industrial life cannot, in spite of vigilance on the part of the above six factors, move steadily forward. There cannot but be cyclical waves and crises as mankind has not the capacity for peering into the future and so regulating the whole development beforehand that it can proceed in perfect proportion. After a time of new creation there must be a time of consolidation and reorganisation. Like the proverbial rings on the tree which usually mark the years of plant growth, business cycles and industrial depression indicate the broad stages in the organic development of industrial life as it proceeds stage by stage.

*Cassel's Criticism.*

Prof. Cassel however disputes not only the above opinion concerning the periodicity of the recurring business cycles but pooh-poohs the opinion concerning the mathematical representation of a business curve, as the exact measurement of human motives cannot possibly be understood aright. He also opines that there has been steady business increase since 1850. This conception of uniform economic progress is corroborated by another great statistician and scholar, Dr. Carl Snyder, who supports this theory from the experience of the U. S. A. economic conditions. Both

these eminent writers stand opposed to the theory of pendulum movement which has hitherto been supposed to be the characteristic of economic life. This key-note of "uniform development of progressive economy is always the basic point of his study of industrial fluctuations." In his Rhodes Memorial Lectures delivered in the Trinity term of 1932 he says "that a true understanding of the uniformly progressive economy is an indispensable preliminary to the study of industrial fluctuations." A carefully regulated planning in advance of the industrial machine would enable us to check extreme fluctuations leading to nation-wide unemployment and misery.

*Economic planning as a panacea.*

The idea of economic planning is nothing new nor strange. It is as old as civilisation itself. The early economic theorists such as the Mercantilists had a plan of their own to increase national prosperity. There has not however been any conscious application of this national planning idea to the industrial organisation and economic system as a whole. American industrial engineering for example is nothing but deliberate planning. The scientific management of Taylor signifies conscious planning in the factory organisation of any industry. These sporadic ideas, so rich and pregnant with meaning, ought to be applied on a nation-wide scale. The triumph of the forcibly adjusted industrial organisation from the peace-time to a war-time basis is a standing example of the fruitfulness of the national economic plans.

Government-controlled and Government-operated enterprises and other specially organised forms of industrial self-government are standing monuments of the superiority of organised schemes over those of the unplanned capitalistic ventures of the modern day.

*Economic planning in action.*

Germany, France, Italy and the whole of Western Europe are now replanning their entire economic organisation with the view of maintaining a balanced economic life for their nationals and have a secure basis for relative economic progress. In spite of unpreparedness Russia's five-year planning has become a watch-word in the field of modern economics. In spite of several undisputed benefits there have been remarkable mistakes arising out of the five-years' plan. A highly centralised socialistic system has been built out of an uneducated, superstitious agricultural population such as the Russian peasants. All branches of national economy such as industry, agriculture and transportation have been studied in detail and the individual original requirements of economic area are also analysed so that optimum economic development might be assured as a result of co-operative efforts and improved production.

*The limitations of planning.*

The limitations of planning must be consciously recognised. Although individual industries are carrying out schemes of rational organisation still it is inferior to the National Economic Council's planning

of the entire industrial life of the nation. Producer's organisations might simply aggravate depressions and unduly prolong them. A depression arising out of credit infirmities would be beyond the pale of their active control. During falling prices producers become anxious to maintain the higher older level. Again some amount of external readjustment would enable the "sick industries" to flourish against adverse external factors.

*National Economic Councils.*

A national economic Council would certainly meet with better success but even this body would find several things beyond its control. Again it might commit mistakes. The opposition of special interests would nullify the recommendations of the N. E. Council. The N. E. Council cannot go far in stabilising investments and savings. Popular prejudice, ignorance and misunderstandings would stand in the way of executing the intentions of the N. E. Council.

*Conclusion.*

As prevention is always much better than cure each nation has to control and master its own fate and a national economic council is an indispensable prerequisite in this direction. Men possessing wisdom, courage, economic knowledge and broad sympathies should form members of this economic council. The plane of economic thinking would not only be lifted to a higher level but their collective effort would find a satisfactory solution for the problems facing the

national situation. The economic system can be organised and worked out to produce brilliant and astonishing results.

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# Appendix I.

## Commercial Banks-Assets and their Percentage of Total.

| Countries. | ASSETS (1929). | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Cash. | Other cash items. | Discounts. | Investments. | Participations. | Correspondents. | Loans and advances. | Cover for acceptances. | Business. | Total. |
| Austria ... | 3·1 | ... | 11·9 | 3·6 | 6·6 | ... | 73·8 | 0·1 | 0·9 | 100 |
| Belgium ... | 9·7 | | 17·2 | 15·1 | | 48·1 | | ... | 9·9 | 100 |
| Czechoslovakia ... | 6·6 | 3·4 | 8·9 | 8·9 | 3·4 | 67·5 | | ... | 1·3 | 100 |
| Denmark ... | 2·7 | 0·9 | 14·2 | 20·5 | ... | 7·6 | 51·2 | 0·1 | 2·8 | 100 |
| Finland ... | 2·3 | 0·6 | 31·5 | 2·5 | ... | 2·2 | 58·4 | ... | 2·5 | 100 |
| France ... | 13·6 | .. | 49·8 | 1·3 | 0·8 | 30·4 | | 3·5 | 0·6 | 100 |
| Germany ... | 1·5 | . | 19·1 | 3·4 | 2·3 | 11·1 | 58·3 | 3·6 | 1·7 | 100 |

| | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Greece | ... | 7·0 | | 22·2 | 12·0 | 2·6 | 10·2 | 43·2 | ... | 2·8 | | 100 |
| Hungary | ... | ... | 6·9 | 42·2 | 2·8 | ... | 45·4 | ... | 5·8 | 2·1 | | 100 |
| Italy | ... | ... | 8·4 | 38·6 | 5·8 | 4·7 | 27·4 | 8·8 | 5·8 | 0·5 | | 100 |
| Netherlands | ... | 4·7 | ... | 20·9 | 5·1 | 2·1 | 5·6 | 53·6 | 6·5 | 1·5 | | 100 |
| Norway | ... | 3·4 | ... | 21·4 | 17·1 | ... | 10·6 | 45·1 | 1·0 | 1·4 | | 100 |
| Poland | ... | 4·2 | 1·1 | 37·0 | 2·7 | 1·7 | 4·8 | 43·2 | ... | 5·3 | | 100 |
| Roumania | ... | 8·1 | | 38·8 | 3·4 | 4·4 | 42·1 | | ... | 3·2 | | 100 |
| Sweden | ... | 1·6 | 0·9 | 20·3 | 7·7 | ... | 5·8 | 62·0 | ... | 1·7 | | 100 |
| England and Wales | ... | 11·1 | 10·4 | 10·0 | 11·6 | 1·1 | 45·9 | | 8·0 | 1·9 | | 100 |
| Scotland | ... | 20·0 | ... | 6·9 | 26·9 | ... | 42·6 | | 2·1 | 1·5 | | 100 |
| Ireland | ... | 10·7 | ... | 2·4 | 41·2 | ... | 44·3 | | ... | 1·4 | | 100 |
| Yugoslavia | ... | 4·6 | ... | ... | 32·6 | 6·3 | 51·2 | | ... | 4·9 | | 100 |
| Canada | ... | 8·3 | ... | 4·9 | ... | 6·8 | ... | 2·6 | 71·7 | 0.6 | 2·7 | 100 |
| U. S. A. (all Commercial Banks). | | 6·6 | .... | 2·9 | ... | 22·4 | ... | 5·7 | 5·89 | 0·8 | 2·7 | 100 |
| Argentine (1928) | ... | 18·2 | ... | 2·7 | 36·4 | 4·3 | ... | 6·5 | 29·1 | ... | 5·7 | 100 |

## Liabilities and their Percentage of Total.

LIABILITIES.

| Countries. | Capital. | Profit and loss. | Notes, Cheques and Drafts. | Deposits. | | | Rediscounts and other borrowings. | Acceptances. | Correspondents. | Total. |
|---|---|---|---|---|---|---|---|---|---|---|
| | | | | Current account. | Others. | Total. | | | | |
| Austria ... ... | 13·0 | 0·7 | ... | 58·6 | 9·5 | 68·1 | ... | 7·1 | ... | 100 |
| Belgium ... ... | 19·2 | 1·7 | ... | 61·4 | 17·7 | 79·1 | ... | ... | ... | 100 |
| Czechoslovakia ... ... | 10·8 | 0·8 | ... | 32·5 | 29·8 | 62·3 | ... | 1·3 | 26·1 | 100 |
| Denmark ... ... | 14·7 | 1·3 | ... | 19·3 | 50·5 | 69·8 | 0·7 | 0·1 | 13·4 | 100 |
| Finland ... ... | 15·9 | 2·3 | 1.6 | 14·0 | 56·6 | 70·6 | 5·0 | ... | 4·6 | 100 |
| France ... ... | 8·3 | 0·9 | ... | 77·7 | 9·5 | 87·2 | ... | 3·6 | ... | 100 |

| | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Germany ... ... | 8·4 | ... | ... | 18·4 | 39·0 | 57·4 | 7·9 | 4·7 | 21·6 | 100 |
| Hungary ... ... | 14·2 | 1·4 | ... | ... | ... | 65·4 | 19·0 | ... | ... | 100 |
| Greece ... ... | 16·9 | ... | 0·7 | 51·0 | 28·4 | 79·4 | 2·6 | ... | ... | 100 |
| I aly ... ... | 11·1 | 1·2 | 2·8 | ... | ... | 14·4 | .. | 5·7 | 64·8 | 100 |
| Netherlands ... ... | 20·2 | 1·4 | 2·3 | 32·1 | 35·4 | 67·5 | ... | 6·5 | 2·1 | 100 |
| Norway ... ... | 15·5 | 0·7 | 0·8 | 18·9 | 7·3 | 55·2 | 62·5 | 0·6 | 1·0 | 100 |
| Poland ... ... | 12·4 | ... | ... | 23·0 | 21·8 | 22·6 | 44·4 | 20·2 | ... | 100 |
| Roumania ... ... | 18·4 | 2·4 | 0·4 | ... | ... | ... | 63·7 | 15·1 | ... | 100 |
| Sweden ... ... | 16·5 | ... | 1·8 | 6·4 | 13·1 | 56·2 | 69·3 | 5·9 | 0·1 | 100 |
| Switzerland ... ... | 13·0 | ... | ... | 8·0 | 21·8 | 51·8 | 73·6 | 1·2 | 4·2 | 100 |
| England ... ... | 6·3 | 0·3 | ... | ... | ... | ... | 85·4 | ... | 8·0 | 100 |
| Scotland ... ... | 8·9 | 0·6 | 7·8 | ... | ... | ... | 80·6 | ... | 2·1 | 100 |
| Ireland ... ... | 8·9 | 0·5 | 5·0 | ... | ... | ... | 85·6 | ... | ... | 100 |
| Yugoslavia ... ... | 17·5 | ... | ... | ... | ... | ... | 78·0 | 4·2 | 0·3 | 100 |
| Canada ... ... | 8·6 | 0·5 | 5·2 | 3·5 | 23·3 | 53·4 | 76·7 | 2·3 | 3·2 | 100 |
| U.S.A. ... ... | 13·2 | 1·6 | 2·5 | 6·2 | 40·8 | 32·2 | 73·0 | 2·7 | 0·8 | 100 |
| Argentine (1928) ... | 11·7 | 0·4 | 0·7 | 7·3 | ... | ... | 80·5 | ... | ... | 100 |

## Appendix II.

### Central Banks and Speculation.

The experiences of the years 1928 and 1929 which the American Banking world did undergo as a result of the stock market speculation are not worth while being recounted in full. But the disastrous fall of securities' prices in November, 1929, meant the withdrawing of non-bank money from the short-term money market and the New York City banks had to fill in the gap to a great extent and commodity markets were immediately affected. It initiated and contributed to the severity of the general trade depression and many country bankers of the U. S. A. have failed in 1930 as a result of frozen loans due to deflation in land values which have been taken as security for bank loans. So some method of intensified and effective central bank control is being considered desirable in order to prevent such extreme demoralisation on the part of bank executives during normal times of banking activity and to obtain the maximum of efficiency from the American banking system.

The Wall Street crash has sent back money to Europe as the deflation of brokers' loans from 7,000 billion dollars to 3,500 released floating money which ran to London for safe employment. Thus this event has some domestic as well as international importance.

But this article pays emphasis to the salient lessons that India ought to learn from the disaster. The attitude of our banks towards the utility of centralised control, *i.e.*, the Reserve Bank (which would be created in the near future) and the reorganisation of some

of the stock exchange practices are important issues which cannot be neglected any longer. But the mechanism, personality, functions and operations of the stock exchanges are not dealt with in this essay. As higher industrial concentration will tend to be the order of the day in this country it would be wise to set right the machinery of stock exchanges as early as possible so as to make all securities liquid.

## The American Speculation Craze.

The United States of America has often witnessed periodical " shake-outs " when unfortunate speculators were generally picked dry in the process of getting rich quick. But the recent speculative crash on the Wall Street is of more than ordinary interest, for very important lessons can be learnt out of this debacle by those willing to profit by the example of others. As soon as the speculative boom tends to subside the stock and shares naturally get into " strong hands " who are not inclined to play the fools' game. Besides this usual weird effect the speculative outburst in the Wall Street during the years 1925-29 has produced several important consequences on the world's monetary history.

## The Early Stage of the Speculative Mania.

" Man proposes but God disposes," says the common adage. With the most benevolent intentions of conferring a real boon on the war-worn Continent of Europe, the late Mr. Benjamin Strong, Governor of the

Federal Reserve Bank,[1] initiated the wise step of encouraging the flow of gold back to Europe by means of low discount rates cheapening money at home.[2] But the American public began to make a naughty use of the easy and cheap money supplied to them by the F. R. Banking system.

From 1922 the security prices were slowly rising but began to slump down in January and February, 1928. But the final check to the speculative orgy was administered only in October 1929. As a matter of fact it took a pretty long time and several undreamt of steps had to be taken by the banking authorities in order to stop the momentum of a four years' rise in stocks and shares.

Initiated in 1925 [3] the American public soon began to gamble in the price of stock and shares. An enterprising press soon began to furnish the credulous public

[1] This aim unfortunately ran counter to the other objects of the F. R. Board. As the proposed aims of the F. R. Board were not clearly formulated the end in view was not often realised. Nothing is more important for the F. R. Board than to give up the pursuit of aims which are contradictory in nature. The "needs of business" or "international considerations" require low rates of interest but this would aim and abet the speculative tendency as it were. Credit restriction would undoubtedly restrict its overwhelming desire to aid agricultural production.

[2] From the autumn of 1927 to the middle of 1928 gold to the extent of 600 millions, flowed out of the U. S. A. (see the F. R. Bulletin, January 1930, p. 8).

[3] From 1925 to 1928 building and other constructional businesses were on an unprecedented scale and caused a huge growth of business profits. Hence the market value of securities began to rise from the beginning of 1925. Flourishing business conditions initiated the boom.

with financial tips for the new class of speculators. But the speculative sun did not begin to shine brightly until September 1927, when the low rediscount rates of 3 per cent. were maintained by the F. R. Board to allow gold to flow to Europe to help the processes of monetary reconstruction and internationalise the gold standard. Easy money, maintained artificially, tempted people to speculate and there was wide public participation in the stock and share market.[1] There was unbridled speculation on their part which did not heed the fundamental forces of demand and supply.[2] This soon proved a source of danger to productive activity, savings, banking institutions and everything else in society. The extent of public participation can be gauged by the mere fact that several stock-brokers had to arrange special compartments in their office premises to accommodate the women speculators. Another relevant fact which can make the reader visualise the dizzy height of the speculative movement, is that on a

[1] The Commercial and Financial Chronicle says that " Every one became seized with the idea that it was possible to get rich overnight by simply taking flyers in the stock market. Accordingly everyone became fascinated with the fluctuations on the stock exchange and everyone participated therein. Scrub-women, porters, elevator boys, typists, boot-blacks, soda-fountain attendants, clerks, statisticians, actors, actresses, and business executives—all classes became a prey to the speculative craze."

[2] Safety, yield and capital appreciation are generally the triple forces that directly influence the value of the securities. These are sold at 30 or 40 years' purchase of the yield of securities. Other considerations such as good or bad trade, psychological influences, bank rates, and special considerations concerning industries also played their part in determining the value of securities. See H. Wither's " Hints about Investments. "

single day, *i.e.*, March 13, 1928, a total of 3,947,530 shares, changed hands. As stated already the slump began to be felt in January and February 1928, so that this figure pertaining to the operations in March do not really indicate the most upward tendency in the "battle of the billions" as the speculative fever has been aptly designated by the imaginative press.[1] There were often in the earlier boom days five and six million-share days. Another way of pointing out the extent and nature of universal participation in the stock market can be resorted to. The following speech of Signor Benito Mussolini makes the above fact apparent. Says he: "Everyone gambled on the stock exchange and since stocks rose incessantly everyone bought at 20, sold at 100 and pocketted the difference with which he purchased a motor-car, a radio-set and telephone or made a trip to Europe, paying for it by instalments and built a house in the country." [2]

Not concerned with the task of relating the story of the speculative boom, attention is mainly rivetted in this article on the salient features of the banking responsibilities and the way in which the F. R. Banking system discharged them.

Although sound homilies were being preached now and then, condemning the reprehensible uses of the ill-gotten wealth of the speculators which was mostly spent on articles of luxury or semi-luxury such

1 "On one day alone 17,000,000 shares changed hands which was a record for Wall Street."—Annual Register, 1929.

2 See "Literary Digest," May, 1931.

as automobiles, art importations at fabulous prices, wearing apparel and dress accessories—still nothing serious was attempted by the banking system till 1928. Mob psychology ruled the prices of stocks and shares out of all proportion to the income-earning powers of the companies.[1]

The first measure of the F. R. Board was more of the nature of a temporary 'warning' than a stern administrative measure checking the abnormalities of insane speculation. The sale of Government securities to the extent of $ 725,000,000 was the first indication of real activity on the part of the F. R. Board. It sought to apply a gentle brake on speculative activity by tightening credit resulting out of the above open market operations.

Nextly, it encouraged the free flow of gold from the country on the understanding that the psychological influence of the departing gold stock would arrest the speculative activity. Even this method of attacking speculation proved futile.

Thirdly, the Chicago F. R. Bank raised its rediscount rate from 3½% to 4½% in January 1928, as a warning to the speculative element in Wall Street. The object of the high rate was to attract gold from

1 There are some writers who consider that this is not the first step taken by the F. R. Banking system to check speculation. Firstly, in the winter of 1927 to 1928 the F. R. Banking system refused to replace the exported gold by the process of purchasing government bonds on the open market—a policy which it generally pursued up to this time. This was more a *negative* measure than a positive attempt to check speculation. See Dowie, "American Monetary and Banking Policies," p. 282.

the East to the Middle Western States. The F. R. Banks of Richmond, New York, San Francisco and Minneapolis soon followed suit and evinced a desire to curb the speculative tendency. But these high interest rates proved negligible factors in curbing the speculative enthusiasm.

Such high rates in the different regional F. R. Banks of the U. S. A., soon tempted the short-term floating balances to return back to America to earn the high rates of interest. To check this adverse factor the other money centres were forced to raise their bank rates.[2]

Even with high bank rates (4½% rediscount rates) and high call money rates ranging at 6% on April 18, 1928, the banking system could not check the tide of speculative activity as trade corporations and other non-bank lenders soon entered the lucrative field of short-term lending. Deterred by high money rates kept up by the banks the brokers increased their dependence on these outside resources and the " bootlegging profits " of the corporations were employed as short-term loans instead of being declared as honest dividends to the shareholders or kept as deposits in

[1] It is only a broad generalisation of this tendency which makes the joint authors remark that Stock-Exchange speculation cannot be governed by variations of interest rate. See R. N. Owen and C. O. Hardy, " Interest Rates and Stock Speculation."

[2] The monetary pressure on other centres can be indirectly measured by increase in the stock of U. S. A.'s gold between June 23, 1928, and Jan. 11, 1929, to the extent of 7 millions of dollars and between that date and 23rd October, 1929, by a further accretion of 282 mil. worth of gold.

banks earning the low deposit rate of interest. It was this money contingent from abroad and domestic non-banking resources that led to the free supply to the brokers and one calculation (New Republic) states that these outside sources lent roughly one quarter of the credit needed by the brokers. Such artificial stimulation defeated the tactics of the F. R. Banking authorities, who soon realised that stock and share prices could not be maintained at such high levels. It thought that " the gambling stage of the bull movement " was reached and it expected a long and slow decline in prices. But its anxiety not to punish the innocent along with the guilty forced it to be lenient and further drastic repressive measures were not undertaken. Brokers' loans could not indeed be curtailed without hurting legitimate business needs at the same time.

But the above opinions were considered unduly pessimistic and a large number of well-informed writers began to maintain that this activity or upward swing in stock prices meant only a reflection of the increased business and productive energy of the people of the U. S. A. As Mr. Moody stated, America became a creditor nation and the development of mass production became a settled fact. New industries and inventions added to the wealth of new products. Conditions of labour and politics continued to be steady and healthy prosperity was engendered by the improved credit arrangements of the F. R. Banking system. The inevitable result of all these forces and prosperity propaganda was the cumulative activity on the stock

market.[1] This speculative craze was adroitly interpreted as a healthy sign indicative of real prosperity. Enthusiasm was catching and the speculative wave could not be checked by moral persuasion, credit restriction, and the tightening of money rates by the banking authorities.

Sympathetic speculative booms began to appear on the London Stock Exchange and the Paris Bourse by June, 1928, and speculation became universal in all the chief monetary centres. The emotional optimism so characteristic of the days of prosperity was mainly responsible for this activity.

Thinking that a stronger medicinal dose would allay the speculative fever the rediscount rate was raised to 5% in July, 1928. The open market operations were strengthened and a large batch of securities was sold to tighten money. The open market acceptances fell to a low minimum of $75 mil. by July, 1929.

[1] One view was that the broker's loans in the New York money market were after all the result of increased economic and fresh industrial activity resulting in new company flotations and the credit situation is, after all, not very abnormal and "there is no reason," says E. P. Stoker, a practical banker, "why Washington should shiver at the broker's loans as though it were being pursued by Banquo's ghost." Broker's loans or stock market loans are to the extent of 5,550 mil. and railroad industry are flourishing and a glance at the business situation reveals that the loans might after all be necessitated by the extension of these industries. The existence of stable commodity prices and business prosperity are leading to a vigorous criticism of the F. R. Board's policy of "tight money" with a view to squeeze credit out of the share-market. See Mr. Simmon's Letter, "The Economist," May 25, 1929, p. 1163.

No stronger action could be taken as the crop-moving season commenced in August and September 1928. Fearing the administering of a check to legitimate business and lawful industry the banking authorities relied more on the moral suasion tactics and pressure upon New York member banks rather than on high interest rates. But as soon as the busy season was over the F. R. Board once again displayed its real intentions and began to initiate high money rates to deflate speculation. By legitimate appeals and tactful warning and carefully influencing the member banks and other commercial banks it attempted to check the speculative use of credit. On February 7, 1929, the F. R. Board issued the following significant statement indicative of its intentions and real policy. "The F. R. Board neither assumes the right nor has it any disposition to set itself up as an arbiter of security speculation or values. It is however its business to see to it that the F. R. banks function as effectively as conditions permit. When it finds that conditions are arising which obstruct the F. R. Board or the F. R. bank in the effective discharge of their functions of so managing the credit facilities of the F. R. system as to accommodate commerce and business, it is its duty to enquire into them and to take such measures as may be deemed suitable and effective in the immediate situation, means to restrain the use, either directly or indirectly, of the F. R. credit facilities in aid of the growth of speculative credit."

This solemn determination was not accepted willingly by the financial world and those who were

most impudent in their challenge asserted that " it was no part of the duty of the F. R. Board to deflate speculation." It was interpreted as a long bowshot beyond its proper function. The Wall Street Journal defiantly asserted that " the business of F. R. Board was banking " and that the country does not expect it " to regulate Wall Street, stabilise farm prices, control prize-fighting at Madison Square Garden, ameliorate the traffic congestion on Broadway and wash the baby in its spare time." In short, it did not want the F. R. system to cut short the country's nascent prosperity.

The F. R. Board, however, stuck to its original intentions and soon established it as the duty of the banking system to see that the public is not only adequately supplied with money and credit on reasonable terms but that they do not make an improper use of credit. The rediscount rate was raised in August 1929 to 6 p. c. and the call money rate swung to a high level of 20 p. c. in March, 1929.[1]

Staggering under a load of heavy money rate the speculators soon realised that a true connection existed between business prosperity and the value of the share. The bear contingent, the increase in unemployment, and reports of poor earnings of the companies—gave the finishing knock-out blows to the reeling and groggy speculators. But it was established beyond doubt that it is the duty of the Central Banking organisation not

[1] The Usury Laws do not apply to the call rates in the New York money centre nor to the rediscount rates of the F. R. system. See J. M. Clark, " Social Control of Business," p. 453.

only to provide the *volume of credit* needed but *its distribution and administration are no less important and vital to the society than mere volume alone.* This can be achieved by placing restrictions on total loan amounts which can be made to individual brokers. But this cannot be secured unless greater publicity of banking operations exists than at present and the C. R. bank which detects this tendency can promptly refuse to rediscount for those erring banks which show increasing advances to those dabbling on the stock exchange.

So now, perhaps, we are in a position to understand the salient lessons we have to learn from this speculative crash. Lesson Number One is the duty of the banking authorities to see that the volume of credit alone is not the main consideration ; every endeavour should be made to check 'naughty' uses of credit.[1] Commercial credit should be used for legitimate short-term productive purposes and the purely speculative or financial uses have to be curbed in right earnest. [2] As in the U. S. A., there would be in every other country banks prepared to finance the worst forms of speculation and then run to the stronger financial institutions for help. Such financial misdemeanour must be checked.

[1] See the recently broadcasted speech of Right Hon'ble Reginald McKenna, on January 3, 1930, quoted from the Bankers' Magazine.

[2] Prof. J. M. Keynes expresses this fundamental truth in dignified language as follows :—" The main criterion for interference with a " bull " or a " bear " financial market should be the probable reactions of the financial situation on the prospective equilibrium between savings and new investment."—Vol. I, p. 257.

Lesson Number Two is that speculation can be properly conducted only by those who have given all their lives to the study of it. "Successful speculation is a whole-time job," says S. A. Moseley, a practical financier of great repute. Conducted by the ordinary man in the street it becomes a mere fool's game and although one view opines that momentarily neither the industrial expansion of the country might be checked,[1] nor the prosperity of the country might be adversely influenced, still the world as a whole would feel the material harm in the long run. Money rates had to rise in all centres to prevent the outflow of money to the U. S. A. A severe spasm of worldwide monetary stringency impeding the legitimate productive efforts of other countries ensued and induced the tendency towards falling commodity prices. This was the unfortunate result of the efforts of banking authorities to check speculation.

The succeeding world depression has been rightly traced to the speculative boom and its effects on the foreign money markets.[2] Steadiness in money rates is no less essential, and international central banking co-operation should consider this as one of its important objectives.

[1] This view should certainly be criticised, for even in the short period there was restriction of credit the collateral shares against which credit is created have fallen greatly in value. As the speculative movements run over a great period of time, savings bank accounts shrink and exports fall off, for with the restriction of credit to debtor countries they cannot absorb the exports of the speculating country.

[2] See Mr. Reginald McKenna's address at the last Annual Meeting (1931) of the Midland Bank.

Lesson Number Three is the extreme caution that is needed even by issue houses and investment trust companies to conduct their operations during such times of disturbed public psychology as in the days of abnormal speculation. No sound investment trust ought to depart from the principles of diversification, intelligent management, compulsory formation of reserve and the reinvestment of a portion of its profits in the shares of important companies. Some of the American investment trusts did indeed conduct operations in a questionable manner, so as to deserve the castigation of that eminent practical financier, the late Mr. Paul Warburg. He designated them as " incorporated stock pools" and did not hesitate to decry them as "subtle instruments of stock-market inflation." But elsewhere in Great Britain as well as Scotland, the *pure* investment trusts have done sterling service to teach the superiority cult of the ordinary share over the Government bond. Investment trusts [1] can certainly do this better than ordinary investors in this respect and these have to be started in each country. If banks were to merely own investment companies or form holding companies to enable them to undertake the promotional part of their business, there might be success for the share-holders for the time being. But as the, encouragement of speculation is not the proper function of commercial banking, this speculative tendency of bank-owned investment companies has to be checked by the passing of restrictive legislation.

[1] See Dr. L. R. Robinson, " Investment Trust Organisation and Management."

Lesson Number Four is with reference to the stock exchange organisation. The one significant lesson it taught was to introduce more specialisation in the mechanism of the Wall Street. New markets for stocks arose in New York. The Curb Market, the Real Estate Securities Exchange [1] and the Produce Exchange Markets for real estate bonds and stocks arose as a result of the speculative demand for these different kinds of stocks and shares. Besides this horizontal expansion of the N. Y. Stock Exchange organisation, improvements were brought about in the matter of listing the shares of new companies on the stock market. This by itself would not check speculation but the investments of the public may be guided into channels of safety. The quotation of shares of properly developed companies is all that is needed. The formation of Industrial Finance and Investment Corporation in Great Britain by the late Lord Melchett [2] was definitely meant to place before the public for issue only such companies that deserve to succeed. An effective check against the flotation of unsound companies is what is needed. [3] The insistence on the mentioning of complete details in company prospectuses would also check unwise speculation.

[1] This was constituted on 13th March, 1929, so as to provide a regular place for trading in real estate securities. Now that mortgage bonds are to be created in this country by the land mortgage banks a similar market for these mortgage bonds would be needed and there would be more people willing to come forward to invest in these mortgage bonds.

[2] See Hartley Withers, "The Quicksands of the City," p 128.

[3] See the Macmillan Committee Report, pp. 167-68, para. 388.

Lesson Number Five is that weak punters who depend on outside help to carry on their speculative deals were the first to suffer. Speculating with other's money in an uninforming manner, meant disaster to themselves as well as the lenders. Some of the banks also suffered as a result of the bank officers speculating with bank's money embezzled by them.[1] They were the people who could least afford to lose the money, yet the temptation was so irresistible that they yielded to it when they were unable to afford to lose even the margin. It meant terrible loss to themselves and the banks.[3] The psychology of fear induced by the sudden collapse of stock speculation had its own reaction on the psychology of the businessmen who are not now cheerfully responding to the bait of "easy or cheap money" artificially created by the banks.

Lesson Number Six is the advisability or otherwise of the independence of the regional branches of a central bank operating in a big country. Now, if India were to decide to fall in with the regional plan basis of the Reserve Bank it behoves us to realise the necessity

[1] See my paper submitted to the recent Lahore Economic Conference, January 1931.

[2] One of the suggested reforms is to check "margin-trading" on the stock exchange. The idea is to restrict it only in the case of the big people who maintain £10,000 margin accounts. But as genuine purchasers of stock are always few there would be no liquid market for any security if 'margin-trading' and the 'floor trader' are prohibited.

[3] From 19th September, 1929, when stock values reached their greatest height, to 13th November, 1929 when they fell to the lowest level, security holders suffered a loss of $8,000,000,000, a sum greater than the entire cost of war to the U. S. A. See the Annual Register, 1929 volume.

for the independence of the regional branches of the reserve bank. A rigid uniformity in the matter of rates can and need be enforced only in the days of national or international necessity. There would be radical differences in the rediscounting obligations in the different regional centres due to natural differences in financial requirements. Hence some of the branches may maintain lower rediscount rates (*i.e.* ½ per cent. lower than any other rates of other branches). In the U. S. A. some of the five federal reserve banks maintained roughly 4 per cent. while the remaining seven maintained only 3½ per cent.[1] But it must be admitted that the F. R. Board has not yet mastered the technique of harmonising the different regional requirements and fusing them, if needed, into a single national discount policy. The rate-fixing power is not yet placed in the hands of the F. R. Board. (Dec. 1930.)

Lesson Number Seven is that we have to revise our banking knowledge in more directions than one. The older conception of banking was to have a small turnover of business, maintain excessive rates of interest and high exchange charges. This has been given up for the modern conception of bigger turnovers and lower interest rates. Another old-fashioned faith which has to be discarded is the ability of the

[1] See the Literary Digest, February 18, 1928.

[2] The recent American Banking Act of 1933 does not assail the autonomous power of the F. R. Banks in fixing their rediscount rates. Though greater powers are being faced in the hands of the F. R. Board this rate-fixing power is not entrusted to it as yet.

banker to deflate speculation. It is plain now that banks after all cannot hope to deflate speculation. All that the high interest rates can hope to do is " to husband the country's credit reserves, keep the financial hospital beds in reserve for a possible emergency and *help to some extent in curbing dangerous tendencies in the speculative markets.*" [1] Just as the entrepreneur is not deterred by an increase in borrowing rates when he realises that prices are tending to rise in the country market, so also the increased borrowing rates will not deter the speculators so long as enthusiasm is catching and an enthusiastic press is providing them with financial tips of doubtful standing. This does not mean that the banking system should not charge a higher rate for loans on security collateral than on commercial paper collateral. This is a legitimate and lawful device which may go a long way in seeing that bank credit is used for legitimate productive purposes. The curtailing of loans on speculative security basis is seriously advocated by all economists and bankers in the U. S. A.[2]

Lesson Number Eight is the part played by instalment selling or " consumption lending" as the bankers styled it. Taking the National City Bank of New York into consideration; it aimed at the direction of increasing the current prosperity of the U. S. A. by this plan of systematically financing the consumption abilities of the small-salaried borrowers. Small sums

[1] E. G. Nichols in the Chicago Daily News. Italics mine.

[2] See H. P. Willis' article on " Speculative Security Issues in the U. S. A." in the " Banker," 1931.

were generally lent on personal security at 6 per cent. rate of interest for securing home needs and two or three signatures were generally insisted on to eliminate extravagant customers. These loans were made repayable at the end of a year or a period of eighteen months and weekly deposits were accepted from the borrower-customer for the purpose of liquidating the original loan. Undoubtedly society was benefited to a great extent by this plan of consumption lending, but it was this plan that must be held responsible for worsening the speculative situation. As 25 per cent. of the value of the article alone was to be paid at the beginning the borrowers had some money to be utilised in the speculative ventures. While it created abnormal prosperity in the U. S. A. it also facilitated the middle class people to lay by something for being lost in the speculative attempts to get rich quick.

Although this has been the unfortunate result still the " consumption banking," of which America is the pioneer, is a legitimate ideal which would tend to eliminate the heartless pawn-brokers or loan sharks and their unsavoury practices. Philanthropic and self-supporting loan societies and Morris Plan banks were started but the interest charges have not been reduced and the attempt of the larger banks to serve the consumption needs of the people is noteworthy. If a large number of banks conduct this business there is an open and legal market where funds can be secured easily and the extortion of the loan sharks can be evaded. The "uniform small-loan law " which is adopted by some of the States in the U.S.A., tries

to tolerate the existence of the honest money-lender and his 30% rate of interest which covers his costs and risks.

Lesson Number Nine consists in selecting and adopting the wise features of the Wall Street organisation and discarding some of the similar obnoxious features which tend to prevail here as well as in the New York stock market. The membership fees are indeed high in this country than before; for instance, formerly any individual depositing Rs. 5 could become a broker but this admission fee is now raised to Rs. 7,000 in the case of the Bombay Stock Exchange organisation.[2] These associations should be chartered bodies and admission should not depend on individual financial ability alone but three sureties should be provided by every broker as proof of his integrity to perform his contracts.

Secondly the system of monthly settlements prevails in Bombay Share Bazaar or Stock Exchange. The system at Calcutta is somewhat different. There are no settlement days and delivery is theoretically due the second day after the contract is passed and sales of securities are effected for the most part under blank

[1] See F. W. Ryan, "Usury and Usury Laws," pp. 135-37.

[2] The membership fee is Rs. 5,000 in the case of the Calcutta Stock Exchange. There are about 300 in all. There is a committee which governs the Stock Exchange consisting of 14 members.[3] There is nearly a 5 to 16 days' period for completing the contract. The forward business is limited to 5 or 10 per cent. of the total transactions.

transfers.[1] The system of fortnightly or monthly or periodic settlements is preferable as it introduces order in the stock exchange operations of the speculators. The operations on "bear account" would become penalised relatively to those which are conducted for a rise, for with daily or short-period settlements of 5 days as were experimented with on the London Stock Exchange after the war, the former require much larger financial resources than the latter. Forced selling in order to satisfy the system of daily settlements becomes the rule and the slump becomes aggravated as a result of the daily settlement. The restraining action of the bear operations tends to place a natural check on the high level of prices to which shares and stocks may be carried by the speculator. The calls for money on the part of the stock exchange operators would be more frequent under the system of daily settlement, and the call money rates would fluctuate more actively under this system than under the monthly or the fortnightly settlement. These were the defects experienced under the daily

[1] See the Indian Year Book (1927), p. 662. But generally there is a 3-days settlement. But the seller need not compulsorily produce the share at the end of the period. There are no periodical settlements and bears can postpone delivery till they can cover the sales at favourable rates. The author knows several cases when transactions were dragged for several months before the accounts were squared. A penalty for the retention of the blank transfers beyond a certain period can be imposed. The present practice of managing agents making unavoidable delay in sending shares has to be checked. The squaring of accounts at definite periods prevents the indefinite pooling up of risks that prove very dangerous in case any crisis were to develop. This is the rationale why there is insistence on periodic settlements.

settlements or forty-eight-hour period on the Wall Street.[1]

The system of blank transfers is still allowed on the Bombay Stock Exchange and measures to curtail the life of blank transfers are not enforced even at the present day, (23rd January 1931). Since these lines have been written attempts have been made by the Bombay Government to increase the stamp duties in March, 1932.

The system of blank transfers prevailing in these stock Exchanges of ours need not be declared void but as it tantamounts to bad transfer, the delivery transfer deeds should be executed on prescribed uniform contract notes or forms which should have a foil and counterfoil. The Secretary of the Exchange ought to get a copy of the contract.[2] Due taxation ought to be levied on these contractual obligations. A maximum fee of Rs. 40 has been suggested by the Indian Taxation Enquiry Committee. Specially, heavy additional stamp duties can be levied on carry-over contracts.

[1] There are, of course, many defenders of the practice of daily settlement on the stock exchange. Firstly, they tend to check over-commitments. Secondly, the burden of settling 2 weeks' transactions would be very great. Finally, the banks would lose the valuable outlet for their short-term funds. Considering the fact that transactions are few, the first and second advantage will not be realised in actual practice in our stock exchanges. The regulation and flow of credit by banking authorities would be possible under periodic settlements.

[2] An official list of closing quotations can be compiled and published by him. Again it would enable him to keep a good record of all bargains for inspection. A uniform brokerage fee can also be stipulated and enforced.

Another baneful practice which a banker has to check is the habit to refrain from the transferring of the security owing to heavy stamp duty. A fixed lower duty, as is prevailing in England, has to be accepted and this suggestion of a maximum fee of Rs. 10 for the transfer would safeguard the legal position of the banker, and would not deter the borrower from completely transferring the legal ownership to the lending banker.

Lesson Number Ten is the impossibility of rationing credit in an unorganised money market, specially when no personal contact exists between the Central Reserve Bank and the other credit-creating banks. Knowing full well that credit has to be supplied to business concerns at the same old rate as before, every endeavour was made to restrict the speculative uses of credit. A differentiating rate might only mean that re-lending would be done by the legitimate trade borrowers to the speculators who are willing to pay higher rates for the use of money. To draw a line of discrimination between the loans made to the legitimate borrowers carrying on production and speculative borrowers' loans or brokers' loans, as they are termed in the Wall Street jargon, is useless under such circumstances when inter-lending can be made. A more rational procedure would be the limiting, or prohibiting if need be, access to member banks which are abusing the privilege of securing loans by the rediscount privilege at the Reserve Bank. Mere blind rediscounting is totally injurious and a careful analysis of the items of paper for rediscount should be the object of the Central

Bank. A really useful Central Reserve Bank ought not to act merely as a reserve or emergency bank alone but the credit-controlling aspect of its functions ought not to be ignored. Unless this aspect of the duty is enforced there will be a ' saturnalia of loose credit.'

The rationing of articles has been rightly acclaimed as a successful measure but it is impossible to think of successful rationing of credit and doling it out to the trustworthy borrowers alone and refuse the same to others. If this power were to be granted to the banks they would become inquisitorial in nature and unless all banks co-operate this rationing of credit will not succeed. Even legitimate borrowers will not be sure that credits would be extended to them up to the limit required under the rationing régime and they would fall a prey to insecurity.[1] Hence this policy of rationing credit in a decentralised banking system has to be discarded and any other method of controlling credit, say by moral persuasion, discount rates and a rigid examination of the member banks' activity by the C. B. authority, would be preferable to the arbitrary and ineffective remedy of attempting to improve the quality of credit created. Any decentralised banking system—for even in the U.S.A. only ⅓ of the existing banks belong to the F. R. system—cannot hope to improve the quality of credit, for the needed co-operation between the different unit banks cannot exist and co-operation is a thing which can never be enforced from outside on unwilling minds. Hence arises the

[1] See Prof. A. C. Pigou, " Industrial Fluctuations."

necessity for developing a highly integrated banking system where the Central Bank can hope to do something under this heading.[1] This is the main reason why banking amalgamations have to be encouraged, for there can be discipline, drill and decorum in the case of the few remaining units rather than in the case of a motley group or a vast array of bankers. A restraining influence over the general over-extended credit situation can be secured if the policy of restricting or limiting credit to member banks encouraging speculation is pursued by the Central Reserve Bank in the highly organised banking system, and too frequent oscillations of the bank rate can be dispensed with under this régime. This would mean that C.R. Bank's credit control and discipline are virtually existing as a matter of fact. Nothing is more conducive towards the unification of the banking system than this measure. This examination and inspection aspect of central banking would be facilitated if the commercial banks do not undertake " mixed banking " functions on any large scale.[2] The displacing of the Government securities item as far as possible by suitable trade bills would be a desirable innovation in our commercial

[1] See the recently broadcasted speech of Reginald McKenna quoted in the " Economist," January 3, 1931, London.

[2] The extension of the National Bank's activities into the field of trust company and the savings bank was accepted and rendered permanent after the F. R. Act. The McFadden Law of 1927 authorised banks to invest a portion of their savings deposits in mortgages of city real estate so that with " frozen assets " the problem of solving banking stability is not tackled thereby.

banking matters. A trade bill can easily become an ideal banking security if the newly created would-be Acceptance Houses and the rediscounting market were to co-operate with the banks in this respect.

Lesson Number Eleven is the tendency on the part of the U. S. A. banking authorities to place the brokers' loans on a stable footing and independent of the call money of the banks. The Continental Bank of New York recently increased its capital solely to finance the brokers' requirements and pave the way towards stabilising call money rates and the collateral loan market rates.[1] About 350 stock exchange and curb houses hold the stock and the directors are all representatives of the brokerage houses. In addition to this move there is agitation to bring in a reform advocating the fortnightly settlement and an effective clearing system. This attempt to reform the stock exchange organisation is laudable. We do not witness such a thing in *this* country. The wise recommendations of the Atlay Committee were not accepted in the beginning and until 1925 there was no attempt to carry them into execution. It was the ' threat of Government intervention' that brought about some welcome changes. But the call money market in the Presidency Towns is still limited to a few crores and inter-bank transactions in this line are rather frequent.

[1] In spite of this New York City banks have been forced to take up the brokers' loans as the non-banking lenders withdrew their money from the call money market in 1930.

## Conclusion.

The above facts clearly indicate that speculation is inherent in human nature and is an attendant evil in the days of prosperity. So long as 'outside money' can help the brokers, banking systems can do little to check this lawful activity. A unified banking system can however mitigate the evils arising out of unbridled speculative activity. Speculative outbursts would occur now and then thus revealing the imperfections of the economic structure. As one distinguished writer says, "speculation is an inseparable concomitant of any market that is really open and free but what is needed is the pursuit of the golden law of moderation in this as in every other walk of life." Otherwise enterprise degenerates into adventure.

Sound banking management, effectively enforced checks against over-issue of unsound securities and the curtailing of the immense volume of loans for speculative purposes are the only real curbs against the speculative craze. The sound banks should join their hands together and dissociate themselves from the stock-jobbing interests or refrain from forming security affiliates—a practice which most of the National Banks are guilty of.[1]

Education on the part of investors to discount the booming methods of the under-writers who encourage

1 The Bank of the United States which failed in 1930 had 48 affiliates and an affiliate was specially formed for making bank shares active and become widely held by the general public.

the public to buy would also be a welcome feature. Popular support for highly speculative and often worthless enterprises can only be checked in this way.

Apart from the inherent impossibility of checking speculation it is not after all advisable to check speculation entirely, for the restriction of speculation means the reduction of values. Without the speculator the economic benefits of a free market cannot be realised by the producers and consumers of society.[1]

[1] The Leeman's Act of England has wisely prohibited speculation in British bank shares but it has at the same time greatly restricted the market for them.

# Appendix III.

## A Goods Standard

### Part One

*The sponsor of the scheme.*

The ' gold mentality ' of the modern nations has so warped their power of thinking that an " unprejudiced and objective examination " of possible alternatives is not usually forthcoming. Besides, as Walter Bagehot pointed out long ago, " men in high position are incapable of conceiving a far-seeing policy of monetary reconstruction." It is no wonder then that the scheme was sponsored by Mr. Leigh, Secretary of the London Chamber of Commerce.

*" Honest Broker."*

Really speaking what one nation receives from another are goods and services. If trade is in essence " barter " the function of money is to act as an " honest broker." Gold money instead of facilitating this honest exchange has failed to perform this task in a satisfactory manner.

*Inelastic credit.*

The gold monetary economy which suited primitive times now no longer satisfies the nations for it has landed them into a quagmire. For example, if one

country makes a technological improvement it means higher dividends, higher wages, greater output and lower prices for the increased goods. Other countries not enjoying this technological improvement would be forced to lower their prices of these goods if they were at all to compete with the goods of the first country. Although more commodities are produced in the first country the prices cannot expand as a result of inelasticity of credit mechanism based on the gold standard.

*All-round lower prices.*

Apparent overproduction in one industry becomes the cause of the general evil of lower prices and other industries are also ruined as production is being restricted to suit the purchasing power.

*Poverty amidst plenty.*

Briefly considered a technological improvement in the gold standard country means under-consumption as a result of lack of purchasing power. If mass production is not followed by mass consumption, which evidently cannot be the case under inelastic purchasing power, there is a breakdown of internal economy due to monetary instability to keep pace with the productive factor. In short, the gold standard mechanism does not give full internal purchasing power so as to maintain a stable general price-level, specially at a time when rapid technological improvements are taking place on the industrial side. Hence the anxiety of the

producers to export their goods abroad and unwillingness to import goods into the country. Poverty amidst plenty has been the resulting feature of the modern gold standard. As production has become stimulated greatly the needed monetary credits cannot be raised as a result of the inexpansibility of the gold basis of credit.

### *The pyramiding of gold.*

While nations have been thus struggling in vain against the defective gold standard the new obligation of paying international war debts has been thrust upon the gold monetary mechanism. As payment of reparations and war debts meant only one-sided flow of gold and the pyramiding of gold in the hands of creditor countries like the U.S.A. and France, the debtor countries have been forced to deflate and the wise creditor countries who had the intelligence enough as not to expand their currencies did not make use of the incoming gold. Banking theorists have unjustly accused them for not making use of the incoming gold and playing the game of the gold standard in right earnest. The U.S.A. at any rate wisely refused to sabotage its own industries by raising the internal price-level and permitting foreign industries to enter the American market. So the creation of stable money co-expanding with the actual volume of production cannot be secured easily under the international gold standard monetary mechanism.

*Other reasons for deposing gold monetary economy.*

Apart from the fact that gold production is inadequate and fortuitous and as world recovery of trade is indeed remote, the needed willingness to co-operate internationally is not forthcoming. The gold fetish has been overdone. Too high a value has been attached by the respective Governments to it and the linking of expanding local currencies at the old values to the gold base is bound to become an impossible feat. So a new monetary economy is suggested by Mr. A. de V. Leigh. Instead of stepping back to the old monetary régime after deposing gold every country should adopt the goods standard whose salient features can be briefly referred to under two headings.

*The external side.*

Each country should have a Central Bank and these Central Banks should meet in a Central Bankers' Clearing House where exchanges would be worked on the old parity. Again all exchanges have to be worked through this Clearing House alone and Central Banking mechanism at the established rate of exchange. Every local currency will have its fixed ratio of exchange with every other local currency and all Central Banks will be represented in the Central Banker's Clearing House.

*Free and independent states.*

These local states will be free and independent under the new monetary system and rid of the necessity

to combine national economic policies with the existence of an overriding international gold standard system which has the unfortunate defect of not being a stable standard of value. The Central Bankers' Clearing House can transfer the claims on the goods of one country to a third and if any return of one country's dues is made it is in the shape of goods or services into the exporting-creditor country. Every import will literally be an order for export and the necessity to send gold on the part of the importing country will not arise. The necessary contraction of currency and the forcing down of prices to a lower level, the reduction of wages and the curtailing of purchasing power which are the usual, indispensable and concomitant features of the gold standard need not arise under the new monetary dispensation.

*The world-equilibrium.*

Under a system where the visible and invisible exports are equal to the visible and invisible imports an equilibrium level will soon be reached. It might be that in some seasonal times a country might export more but it will lead to mere accumulation of short-term credits on the importing country whose internal economy will not be affected in any other way which would have been the result if the countries were on the gold standard. If one country's general price-level were to be far higher than the point of equilibrium, other nations would not wish to buy from it and it will begin to lose its export trade. It would also lose its export trade for other nations might not

agree to take their payments in its expensive goods and would feel reluctant to have short-term credits in that country possessing a higher general price-level than that of the world-equilibrium.

*Intelligent Management.*

Similarly if on account of low standard of living the general price-level of one country were to be lower than that of the world equilibrium, an accumulation of short-term credit on the part of that country would ensue. Unless these are utilised by the country the bank will not agree for an indefinite continuation of this régime and rediscount export bills *ad infinitum* while the rapidly piling up short-term credits are not used by the merchants for importing goods of the debtor countries. Thus an intelligent management of the goods standard is also needed, for if the banks fail to exercise their power of refusing to discount further export bills or if the Central Bank does not remind the banks of this duty, the goods standard does not work. Hence the possibility of keeping the general price-level for long below the world equilibrium will never succeed, for the importer's attempt to introduce goods from the low price-level country can be defeated by raising a tariff wall against them.

Again the low price-level country cannot import high-priced goods and sell it inside the country unless mass purchasing power is increased by payment of higher all-round nominal wages. Thus any deviation from the normal world equilibrium is bound to be

punished and economic forces will be so exerted that the equilibrium point will soon be reached.

*Immunity from external forces.*

Under the gold standard this could never work so smoothly for as soon as gold was sent out a deflationary policy was considered inevitable. An inexpansive gold standard has competitive deflation and not satisfied with this evil it meant forced the competitive nations to lower the exchange value of their currencies so as to undercut the rival competitors. The external forces which act on the internal price-level of a country are too many in the case of the gold international standard. Under the goods standard the internal general price-level would not become subjected to external monetary causes.

*No straight jacket for industries.*

A goods standard means that the supply of credit and currency expands concurrently with the goods factor. Under the gold standard we have already seen that industry is placed in a straight jacket or else forced to sell for lower prices thereby creating further points of disequilibrium in the internal economy of the country. In an age when modern science is fast expanding the quantity of useful goods which people can use to improve their standard of living, money or internal purchasing power ought to expand *pari passu* with the increase in goods. It should not depend on one commodity called gold and its possible concurrent expansion, for it might or might not be forthcoming.

A goods standard can easily secure the necessary criterion of monetary stability which says that monetary tokens must be just equal to exchange deals in goods. "Monetary policy should be so planned," says Sir Basil Blackett in his new book—*Planned Money*, "that monetary tokens just equal the exchange deals." Internal monetary mechanism must expand and contract along with trade activity. While the occurrence of a trade cycle is possible under the gold standard system a goods standard is immune from it, for fresh expansion or contraction of credit does not take place fortuitously but only when genuine trade demand or slackness needs it.

*Rediscounting of Commercial Bills.*

If all eligible commercial bills can be rediscounted with the Central Bank while financial or speculative bills are not rediscounted, the above ideal can be easily secured. The joint stock banks must generally lend only for financing current production and distribution and this can be done by securing an eligible bill form which means a definite undertaking to finance current production and distribution. This bill can be rediscounted by the Central Bank and the member bank's account can be expanded with the new credit, or Central Bank notes can be issued to the member bank if these were needed by the banker. A fixed fiduciary issue of bank notes can be maintained to make the currency system elastic enough to meet the requirements of the population. On the top of this or superimposed on this structure there will be additional currency created

by the rediscounting of eligible trade bills. The credit currency which can be issued by the joint stock banks can be based on 9 : 1 ratio fixed by law. The bank credit currency can expand to nine times the member bank's cash base which has to be controlled by the C. R. bank. This ratio can be subjected to any alteration by the C. bank if it finds speculation or inflation taking place with the help of financial credit.

### *The Controlling of Credit.*

The credit controller in the goods standard is this ratio of financial credit. It will take the place of "the old bank rate and open market operations policy" under the gold standard." If speculation is going on the old ratio of 9 : 1 can be reduced to 8 : 1 or 7 : 1 so that financial credit can be drastically curtailed. The joint stock bank can create credit only against member bank cash or its cash reserve in the hands of Central Bank. This can expand only by the rediscounting of eligible bills. As this can be secured by financing eligible bills alone industry need not be placed in a straight jacket. The internal price-level would be kept in equilibrium with the world price-level.

## Part Two.

### *Criticism of the Goods Standard—Skilful Monetary Manipulation.*

Though it can be easily conceded that the old defunct gold standard is a misfit in this scientific world it will have to be intelligently managed for the time being

before the general run of the people can understand monetary matters and allow it to be skilfully manipulated by the experts solely with the object of achieving monetary stability.

### *Confidence Trick.*

The recent war-time experiments with paper currencies have proved that people have no faith in the paper "simulacrum." The goods standard means circulating paper money as monetary tokens. The confidence trick cannot be played by it.

### *The Cart before the Horse.*

As credit is based on currency the proposed working of the internal system of the goods standard is placing the cart before the horse. It is commercial credit based on the eligible commercial bill that will lead to the expansion of currency.

### *Inalienable Private Right.*

The right to grant credit should not be curtailed as this scheme requires it to be done. The issue of credit is an inalienable right of the private trader or commercialist and modern trade would shrink to an insignificant volume were this right to be curtailed. While the abuse of this privilege might bring disaster on society still its curtailment would lead to a worse situation.

*Impossible to distinguish.*

The drawing of a line of difference between financial and speculative credit on one side and commercial credit on the other is indeed very difficult. The practical safeguard that the eligible bill form which guarantees the utilisation of credit for productive purposes conveys, might be abused. While the quantitative volume of credit might be controlled by an integrated banking system the qualitative nature of credit depends on the borrower. Private re-lending might defeat the intentions of the credit controller.

*What of the time-lag ?*

The financing of the eligible commercial bill might participate something of an inflationary character and lead to excessive credit. At any rate there is a time-lag between the final creation of commodities and the prior creation of credit during which period further credit facilities would have to be raised.

*Permanent fixing of the exchange rates.*

The ratio of foreign exchange rate is not vitally important but it has to be fixed by the goods standard. Following this the internal currencies must be steadied so as to steady the fixed exchanges. Exchange should and ought to vary with conditions of demand and supply. But this scheme ordains their permanence. It is just like steadying the level of mercury in the barometer without steadying artificially the weather conditions outside the barometer. The gold

standard also fixes the exchange within par points in addition to the difficulties incidental to the fixing of exchange ratio under the goods standard.

Although the major exchanges of international trade might be steadied under this scheme, for nothing but bank money will be sold and bought internationally, a variable rate exists for the negligible business of exchanging national against foreign small bank notes and other forms of currency.

*Lack of interchangeability.*

The new scheme means that there is no interchangeability between the respective currencies as in the case of metallic currencies having intrinsic value of their own.

*The tail wagging the dog.*

The practical difficulties in fixing paper exchanges are very many though not insuperable. It presupposes that exchanges and prices are being fixed in the interest of external trade which in the case of some countries forms only a very small portion. It is the dog that should wag the tail and the tail should not wag the dog.

*Hindrance to trade with gold-using countries.*

Unless all countries adopt this goods standard the trade with gold standard countries becomes impeded. At present each country thinks that it has an inalienable privilege to control its credit and currency mechanism in its own interests.

*Highly intractable monetary phenomena.*

The present-day economic difficulties are not the creation of the gold standard. Monetary difficulties might have aided and accelerated the influences arising out of highly intractable non-monetary phenomena such as tariffs, quotas, exchange restrictions, reparations, war-debts, sheltered wages and confiscatory taxation. The new monetary policy called the goods standard will not lead the world out of the wood. It is lacking in certain essential features of stable money. A compensating money of contract is needed and this can be secured if the purchasing power of contractual monetary incomes is protected against the effects of a rising retail price-level as long as production and unemployment increase under the stimulus of rising wholesale prices.

*No demonetisation of gold.*

An improved gold standard would not render necessary the demonetisation of gold needed by the goods standard. No alteration of the existing machinery would be needed if the gold standard can be restored.

*No clean slate.*

This scheme aims wisely at attaining the ideal of international stabilisation of exchanges and the synchronic development of production and consumption in national territories.

As this scheme cannot be promulgated on a clean slate the present-day monetary difficulties created by

excessive investment by creditor countries cannot be solved. Mutual stabilisation of credits are needed so as to place the debtor countries on their economic feet. Finally the uniform application of the Tabular standard principle, *i.e.*, an index currency, has to be developed.

### *The Russian experiment.*

Russia experimented with a goods rouble in 1922 and had to very soon abandon it in favour of gold standard currency. The goods standard has to be given up mainly because the accumulated national claims must be convertible into monetary claims without any loss in the foreign country. The accumulated short credits or foreign goods warrants will fall in value with the growing imports needed by the country and with the diminishing quantity of its exports.

## Part Three.

## Merits of the Scheme

### *Parallel expansion.*

The scheme of the goods standard consists in expanding basic currency along with production and creative business requirements of the community.

### *Actual circulation of money.*

It aims at the circulation of currency in the hands of the masses. This coterminous increase in the quantity of goods and credit (the latter of which is

based on the constant circulation of the standard yard-stick currency) would fix values, stabilise prices and aid the maintenance of prosperous business conditions.

*The barter basis of the scheme.*

The resort to barter basis of trade on which the scheme is conceived is already in existence under the gold standard scheme. The Canadian Dominion has been bartering away excessive wheat for the unwanted coffee holdings of the Brazilian Republic. Russia is supposed to be organising similar exchanges between its oil and Brazilian coffee.

*Producer as the controller of currency.*

It makes provision for the control of the expansion and contraction of currency and credit by the Central Bank. It takes away this control from the hands of the money-lender and dealer who control the monetary metal, *viz.*, gold. The real producer now stands as the controller and creator of basic currency. The control of gold over nations and men has been a tyrannous feature depriving every human being of a fair profit and the means to live in comfort during the transitory period of his life on earth. As all the monetary gold at present mined would form, if melted, into a block or cubic mound thirty-one feet long, thirty-one feet high and thirty-one feet wide it is apparently insufficient to act as standard monetary metal for vastly increasing business requirements of the modern scientific world. It is no use pyramiding credit on a

small pin-point of gold until it becomes top-heavy and crashes to the ground. The true ideal of banking, namely, the permitting of entire business of the nation to run on smooth lines, will be secured under the scheme.

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